



Summary and Answers to Frequently Asked Questions about the June 30, 2007 Actuarial Valuation for the City of San Diego

Updated February 11, 2008

SUMMARY

The June 30, 2007 Actuarial Valuation for the City of San Diego (the “2007 Valuation”) is based on the same actuarial assumptions used in the June 30, 2006 valuation but it reflects a number of methodology changes adopted by the SDCERS Board after careful and public consideration. The methodology changes, which are discussed in the 2007 Valuation, include the following:

- (1) The return to using the most widely-accepted actuarial funding method, Entry Age Normal (EAN), instead of the Projected Unit Credit (PUC) actuarial funding method.
- (2) A 20-year amortization period for the pay down of the June 30, 2007 Unfunded Actuarial Liability (“UAL”). Last year’s June 30, 2006 Actuarial Valuation (the “2006 Valuation”) used a 27-year amortization period that was required to be used through the 2006 Valuation by the Gleason judgment.
- (3) To avoid any “negative amortization” of the UAL, the City will pay the full interest on the UAL in addition to the full Normal Cost.
- (4) The use of the Expected Value of Assets asset smoothing method, which was approved by the Board in September 2006.
- (5) The removal of all liabilities for future payments that are projected to be in excess of the maximum benefit level payable from a tax qualified retirement plan under Internal Revenue Code Section 415. (In the 2006 Valuation, only liabilities for then active members in excess of Section 415 had been removed.)

These are all important and positive changes. Taken together with the changes that were implemented in the June 30, 2006 Valuation (e.g., apportionment of assets based on individual cash flows attributable to each plan sponsor; recognition of “contingent” liabilities; proper treatment of disability payment liabilities; and removal of active members’ future liabilities for payments projected to be in excess of IRC Section 415 limits), SDCERS has completed the transition to using the most widely-accepted, industry-standard actuarial methods used by public pension plans.

FREQUENTLY ASKED QUESTIONS

- 1. Based on the June 30, 2007 Actuarial Valuation for the City of San Diego (the "2007 Valuation"), what is the City's 2007 Unfunded Actuarial Liability (UAL)?**

Using the Entry Age Normal ("EAN") funding method, the UAL was \$1.1842 billion. *[See the 2007 Valuation Letter of Transmittal and the 2007 Valuation at page 3.]*

- 2. How does the 2007 UAL compare to the 2006 UAL?**

Using the Projected Unit Credit ("PUC") funding method, the UAL at June 30, 2006 was \$1.0008 billion *[See the 2007 Valuation Letter of Transmittal and the 2007 Valuation at page 3.]*

- 3. What was the impact of changing the funding method from PUC to EAN?**

The change in funding method from PUC to EAN caused the UAL to increase by \$252.2 million. This increase was partially offset by other factors; see Question 7 below.

If the PUC funding method had been used in the 2007 Valuation, the June 30, 2007 UAL would have dropped 6.9% from \$1.0008 billion to \$932.1 million. *[See the 2007 Valuation Letter of Transmittal and the 2007 Valuation at page 3.]*

- 4. What is the City's 2007 funding ratio?**

As of June 30, 2007, using the EAN funding method, the City's funding ratio, which is the ratio of the actuarial value of assets (after smoothing) over total actuarial liabilities, was 78.8%. *[See the 2007 Valuation Letter of Transmittal and the 2007 Valuation at page 3.]*

- 5. How does this compare to the City's 2006 funding ratio?**

As of June 30, 2006, using the PUC funding method, the City's funding ratio was 79.9%. *[See the 2007 Valuation Letter of Transmittal and the 2007 Valuation at page 3.]*

- 6. What impact did the change from PUC to EAN have on the funding ratio?**

If the PUC funding method had been used in the 2007 Valuation, the funding ratio would have improved from 79.9% to 82.6%.

If the EAN funding method had been used in the 2006 Valuation, the June 30, 2007 funding ratio would have improved from 76.7% to 78.8%. *[See the 2007 Letter of Transmittal and the 2007 Valuation at page 3.]*

7. Why is the 2007 UAL higher than the 2006 UAL?

The City's June 30, 2007 UAL increased by \$183.4 million from \$1.0008 (based on the PUC funding method) to \$1.1842 billion (based on the EAN funding method) for several reasons.

The largest factor in the increase, \$252.2 million, was the change in funding methods from PUC to EAN. For example, if the Board had not changed funding methods, the City's 2007 UAL would have dropped to \$932.1 million. It is important to note that the change to EAN did not create any new pension obligations for the City. Rather, the funding method change from PUC to EAN simply allocates more of the unchanged future obligations to past service and less to future service, and the UAL is an actuarial measurement of the system's past service liabilities. Also, there was an experience loss of \$38.2 million.

On the plus side, even though the new Expected Value of Assets smoothing method only reflects one-fourth of any investment gains over the assumed 8% rate, the City had a \$74.9 million investment gain. In addition, contributions of \$20.4 million were received in excess of those expected. *[See the 2007 Valuation at pages 3 and 4.]*

8. What was the impact of SDCERS using the Expected Value of Assets asset smoothing method for the 2007 Valuation?

The market value of assets of SDCERS' investment portfolio as of June 30 each year provides the principal basis for measuring financial performance from one year to the next. However, market values can fluctuate widely, and if they were used as the sole measure of a retirement plan's assets, they would result in volatility in employer contributions. Actuaries have developed asset smoothing methods to mitigate the impact that annual investment volatility has on the annual funding cost of a retirement system. Asset smoothing minimizes sharp fluctuations in investment returns, which in turn minimizes sharp fluctuations in employer contribution rates.

In September 2006, the SDCERS Board, based on Cheiron's recommendation, adopted the Expected Value of Assets smoothing method for valuations beginning in 2006. The Expected Value of Assets smoothing method is a much more widely-accepted smoothing method than the prior "book value" smoothing method and will effectively mitigate the impact of market fluctuation on SDCERS' plan sponsors.

The Expected Value of Assets smoothing method is calculated by accepting 100% of the assumed return, but only 25% of the returns above or below those expected. On an actuarial value of assets basis using the Expected Value of Assets method, the return for FY 2007 was 9.78%. (SDCERS' assumed return was 8%. Actual returns exceeded 16%, or 8% more than the assumed return. 25% of the 8% above the assumed return is 2%. Adding the assumed return of 8% and the extra 2% determines the 10% Expected Value of Assets return.) *[See the 2007 Valuation at pages 4, 16 and 17.]*

SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM

9. What is the City's Annual Required Contribution (ARC) for FY 2009? (This is the amount the City will have to contribute to SDCERS on or after July 1, 2008.)

If paid in full in July 2008 as expected, the City's ARC payment for FY 2009 will be \$161.7 million (approximately 29% of payroll). If the City instead pays the ARC evenly throughout FY 2009, the contribution will be \$168.1 million (approximately 30% of payroll). *[See the 2007 Valuation Letter of Transmittal and the 2007 Valuation at page 5.]*

10. What was the City's ARC payment for FY 2008?

For FY 2008, the City's ARC was \$137.7 million. However, in FY 2008 the City paid SDCERS approximately \$165 million. The additional \$27.3 million included \$20 million to ensure no negative amortization of the UAL and \$7.3 million to offset contribution shortfalls from prior fiscal years that were identified in SDCERS' IRS Voluntary Compliance Program filings.

11. Why did the FY 2009 ARC increase?

The FY 2009 ARC increased \$24 million. This was due to the move to the EAN funding method (\$6.4 million); the use of the more conservative 20-year UAL amortization period (\$13.1 million); and the extra amount paid to ensure no negative amortization of the UAL (\$9.4 million).

Offsetting these increases, the ARC was reduced by \$4.9 million due to an overall net favorable experience gain.

12. How is the City's FY 2009 ARC calculated?

The City's employer contributions are composed of two components: the Normal Cost (NC) contribution and the UAL contribution. NC represents, for each active City employee, the present value as of June 30, 2007 of the portion of the employee's projected retirement benefit assigned to FY 2009. By paying the NC, the City pays a level percentage of permissible salary to fund for the value of benefits over each participant's career. The UAL portion of the employer contribution is an amount the City pays each year to pay down any unfunded liabilities accrued over past years. The UAL is paid-off ("amortized") over a period of years. The SDCERS Board adopted a new amortization period of 20 years for the 2007 and subsequent valuations plus any additional amount needed to avoid "negative amortization." *[See the 2007 Valuation at pages 5, 23 and 24.]*

13. What was the market value of SDCERS' Trust Fund on June 30, 2007, and what was the City's portion of this amount?

The market value of the assets in SDCERS' Trust Fund on June 30, 2007 was \$4.937 billion. The City's portion of this amount was \$4.641 billion, which represents a net increase of approximately \$648 million. *[See the 2007 Valuation at page 17.]*

SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM

14. How do these amounts compare to the June 30, 2006 market values?

They are 16% higher. The June 30, 2006 market value for the SDCERS Trust Fund was \$4.239 billion, and the City's portion of the Trust Fund was \$3.993 billion. *[See the 2007 Valuation at page 15.]*

15. Why did the market value of the City's portion of the Trust Fund increase?

From July 1, 2006 through June 30, 2007, the City contributed \$169 million to the SDCERS Trust Fund. (\$162 million in July 2006 in payment of the FY 2007 ARC, and an additional contribution of \$7 million in June 2007.) City employees contributed \$67 million, and DROP participants added \$57 million. (The City's FY 2008 ARC of \$137.7 million that was contributed in July 2007 will be reflected in the June 30, 2008 Valuation.) *[See the 2007 Valuation at page 15.]*

Net investment income was approximately \$617 million. *[See the 2007 Valuation at page 15.]*

Offsetting these additions, SDCERS paid \$262 million in benefits to retired Members. *[See the 2007 Valuation at page 16.]*

16. What is the actuary's assumed investment return for the SDCERS Trust Fund?

The actuary assumes a long-term average investment return of 8% for Trust Fund assets. *[See the 2007 Valuation at page 43.]*

17. What were the annualized investment returns of Trust Fund assets?

SDCERS' annualized investment returns for the one, three, five and ten-year periods ended June 30, 2007 were 16.50%, 13.32%, 13.02% and 9.96%, respectively. Annualized investment returns are close, but not identical, to the internal rate of return calculated by the actuary (e.g., 15.13% for the year ending June 30, 2007) because the actuary includes certain balance sheet transactions that are not included in the investment portfolio. *[See the 2007 Valuation at page 17.]*

18. Are the City's retiree health care expenses included in the 2007 Valuation?

No. Health care expenses are a separate obligation of the City, and they are not paid from retirement assets in the SDCERS Trust Fund.

19 What will the 2008 Valuation look like?

The 2007 Valuation reflects all of the funding and methodology changes recommended by Cheiron, the Board's actuary, as described on Page 1 of the 2007 Valuation's Summary Section. The City's June 30, 2008 Actuarial Valuation will continue to use these methodologies and methods.

Actuarial assumptions are periodically evaluated for reasonableness by comparing them to a pension plan's actual experience. In spring 2008, Cheiron will perform a multi-year experience study that will review the actuarial assumptions that are described in Appendix B, Section A, of the 2007 Valuation. This experience study may result in revisions to some or all of these assumptions that will be used in the 2008 Valuation, subject to adoption by SDCERS' Board.

But, remember, whatever the results of the June 30, 2008 Actuarial Valuation are, they, too, will only be another snapshot of the status of the City's retirement plan on that day.