SDCERS June 30, 2016 Actuarial Valuation: City of San Diego
Frequently Asked Questions

At the request of the Board of Administration, Cheiron performed the June 30, 2016 actuarial valuation of the San Diego City Employees' Retirement System (SDCERS). The purpose of the actuarial valuation is to report on the financial condition of the system's Defined Benefit plans for its three plan sponsors – the City of San Diego, the San Diego Unified Port District and the San Diego County Regional Airport Authority. The following frequently asked questions are intended to provide SDCERS' plan sponsors and members with information regarding the valuation's results for the City of San Diego.

The valuation and its contents were prepared in accordance with generally recognized and accepted actuarial principles and practices consistent with the Code of Professional Conduct and applicable Actuarial Standards of Practice established by the Actuarial Standards Board.

FREQUENTLY ASKED QUESTIONS

1. Based on the June 30, 2016 Actuarial Valuation for the City of San Diego, what is the City's Unfunded Actuarial Liability (UAL)?

As of June 30, 2016, the City's UAL was $2.558 billion. The UAL is the difference between the actuarial liability and the actuarial value of assets. Most retirement systems have an unfunded actuarial liability. The existence of an unfunded actuarial liability is not in itself bad, any more than a mortgage on house is bad. The unfunded actuarial liability does not represent a debt that is payable today. What is important is the ability to amortize, or pay down, the unfunded actuarial liability.

2. How does the 2016 UAL differ from the 2015 UAL?

The City's UAL increased by $556 million, from $2.002 billion to $2.558 billion. Approximately $444 million of the increase is due to changes in demographic assumptions, in particular revised mortality assumptions reflecting the increased lifespans of SDCERS' members. In addition, a reduction in the long-term earnings assumption from 7.125% to 7.0% had the effect of increasing the UAL by approximately $100 million. A more complete analysis of the changes in the UAL is provided in the January 13, 2017 actuarial presentation found here.

3. What is the City's funded ratio for 2016 and how does this compare to the 2015 funding ratio?

As of June 30, 2016 the City's funding ratio was 71.6 %, a decrease of 4.0% from 75.6 % as of June 30, 2015. The funded ratio is the ratio of the system's actuarial value of assets to its actuarial liabilities, and a key measurement of the health and stability of a pension fund. The funded ratio had increased for six consecutive years through June 30, 2015. The funded ratio decrease as of June 30, 2016 is primarily attributable to the increased liabilities associated with the revised mortality assumptions noted in number 2 above.

4. What is the City's Actuarially Determined Contribution (ADC) amount for Fiscal Year 2018?

The City of San Diego's Fiscal Year 2018 ADC is $324.5 million. The ADC (formerly known as the Annual Required Contribution or ARC) is the contribution amount determined each year by the SDCERS actuary based on the SDCERS Board's adopted funding policy. The June 30, 2016 actuarial valuation, once approved by the SDCERS Board in March 2017, sets the ADC expected to be paid by the City on or after July 1, 2017, the first day of Fiscal Year 2018. The increase of $63.4 million from the $261.1 million paid in Fiscal Year 2017 was primarily driven by the same factors as those influencing the UAL, explained in answer number 2 above.

5. **How is the City's Actuarially Determined Contribution (ADC) calculated?**

The City's employer contributions are comprised of three components: the Normal Cost contribution, the UAL contribution, and a payment to cover the plan's administrative expenses. Normal Cost represents the present value of the portion of all active SDCERS City members' projected retirement benefits assigned to each fiscal year. By paying the Normal Cost, the City pays a fixed percentage of total pensionable salaries to fund SDCERS for the value of benefits earned that year. If paid at the beginning of the fiscal year, the City's Normal Cost is $51.7 million (approximately 11% of payroll). The UAL portion of the employer contribution is an amount the City pays each year to pay down unfunded liabilities accrued over past years. The UAL is paid off, or amortized, over a period of years. The City's total June 30, 2016 UAL of $2.558 billion is split into several tiers, each using a different amortization period. There are now a total of 19 tiers, and adding the amortization of each tier results in next fiscal year's UAL payment of $324.5 million. Additional information on the June 30, 2016 UAL tiers will be included in the related actuarial valuation report to be released in February 2017. Information on the prior fiscal year UAL tiers is included in Table IV-2 on page 25 of the City's June 30, 2015 Actuarial Valuation.

6. **How does the passage of Proposition B in 2012 affect the ADC?**

Passed in July 2012, Proposition B closed the defined benefit retirement plan for newly hired General, Fire, and Lifeguard Safety members, leaving the plan open only to sworn police officers. The total UAL was unaffected by the passage of Proposition B; however, the amortization of the UAL into annual ADC payments was affected.

A level dollar amortization was applied to the closed plan portion of the UAL to follow Governmental Accounting Standards Board standards in effect in 2012. This level dollar amortization required the City to pay a higher ADC amount in the early years following the passage of Proposition B, and lower payments in later years. The higher ADC payments in early years are expected to save the City approximately $200 million in the 30 years following the passage of Proposition B.

The actuarial funding model followed by SDCERS does not require the contributions of active employees to pay any share of retired employee benefits, which differs from how the federal Social Security system is funded. The passage of Proposition B does not require current members to pay any more or less than they would have paid with an open plan, nor did the passage of Proposition B increase or decrease the City's UAL.

7. **Why are the pension disclosure amounts in the Financial Section of the Comprehensive Annual Financial Report (CAFR) different from the Actuarial Valuation?**

The Governmental Accounting Standards Board recently issued Statements 67 and 68 that revise the standards for pension plan financial reporting. However, the new standards explicitly do not provide any direction for how pension systems are to disclose pension *funding* amounts. Instead, pension systems like SDCERS, upon the advice from their actuary and standards established by the Society of Actuaries, establish separate funding policies and associated financial disclosures. The SDCERS Board has formalized its Actuarial Funding Methodologies and Assumptions policy, available on the SDCERS website under the Resources tab. Financial reporting policies and actuarial funding policies are mostly the same. However, they differ in a few important ways. For example, financial reporting policies use only the market value of assets, while actuarial funding policies use a smoothed value of assets. SDCERS financial reporting disclosures on pension matters are included in the June 30, 2016 CAFR on the SDCERS website.

8. **Are employee contribution rates impacted by changes in the discount rate and other actuarial assumption changes approved by the SDCERS Board in September 2016?**

Yes. City employees will see an increase in their bi-weekly contribution rates, effective in July 2017. As a percentage of pay, rates will be increased by an average 0.6% to 0.8% for most General members, and be increased by an average 0.8% to 1.0% for most Safety members. Exhibits in the January 13, 2017 actuarial presentation available here show the new contribution rates for all members.

9. What was the market value of SDCERS' Trust Fund on June 30, 2016 and the City's portion of this amount?

The market value of the assets in SDCERS' Trust Fund on June 30, 2016 was $6.8 billion. The City's portion of this amount was $6.3 billion. The San Diego Unified Port District and the San Diego County Regional Airport Authority account for the remaining $0.5 billion of the SDCERS Trust Fund.

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

For the June 30, 2016 valuation, SDCERS' actuary assumed a long-term (30-year) average investment return of 7.0% for Trust Fund assets. The actuary uses this long-term expected investment return assumption to set City and employee contribution rates that when combined with investment returns will fully fund future benefit payments.

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

SDCERS' annualized investment returns for the one, three and 10-year periods ended June 30, 2016, as reported by Hewitt EnnisKnupp were 1.1%, 6.8% and 5.9%. Long-term returns over the past 20 years were 7.8%, and going back to when performance tracking began in 1988 the average returns are 8.8%. Annualized investment returns are different from the actuarial rate of return that uses asset values from the Expected Value of Assets smoothing method, explained further in number 12.

12. How does the Expected Value of Assets smoothing method work?

The Expected Value of Assets smoothing method dampens the volatility in asset values that can occur because of fluctuations in market conditions. Use of an asset smoothing method is consistent with the long-term nature of the actuarial valuation process. Assets are assumed to be used exclusively for the provision of retirement benefits and expenses.

The actuarial value of assets each year is equal to 100% of the expected actuarial value of SDCERS' June 30, 2016 assets, plus 25% of the difference between the current market value of assets and the expected actuarial value of assets. In no event will the actuarial value of assets ever be less than 80% of the market value of assets nor greater than 120% of the market value of assets. In the June 30, 2016 valuation, the City's actuarial value of assets of $6.455 billion was 102.3% of the City's market value of assets of $6.307 billion.

13. Why does all of this matter?

The California Constitution requires members of a retirement board "to provide for actuarial services in order to assure the competency of the assets of the retirement system." In simpler terms, the SDCERS Board of Administration must have a funding plan in place to ensure that employer and employee contributions, plus investment earnings, are sufficient to pay future benefits. That objective is met by conducting an annual actuarial valuation that measures the financial condition of the pension plan, analyzes past and expected trends in the financial condition of the plan, and that determines the annual contributions for the coming fiscal year. This well-documented and disciplined process deserves and receives a significant amount of attention from the Board, as it should. The Board welcomes input on this process.