



January 12, 2007

Summary and Answers to Frequently-Asked Questions about the June 30, 2006 Actuarial Valuation for the City of San Diego

SUMMARY

The 2006 Valuation is an important milestone for SDCERS: it reflects the transparent transition from past practices to more widely-accepted and adopted actuarial methods. It is the result of a systematic and thorough actuarial funding study undertaken by Cheiron, the Board's new actuary, and their recommendations that were adopted by the SDCERS Board after careful and public consideration.

In addition to confirming SDCERS' strong investment returns, the 2006 Valuation incorporates the following significant changes in methodology: (1) the apportionment of SDCERS' Trust Fund assets among plan sponsors based on individual cash flows attributable to each plan sponsor; (2) the full recognition and funding of certain liabilities that had been considered "contingent" in nature; (3) the use of a more widely-accepted asset smoothing method; (4) the proper treatment of certain disability payments; and (5) the proper treatment of benefit payments made in excess of Internal Revenue Code (IRC) section 415. All of these changes are reflected and discussed in the 2006 Valuation.

In addition, the Board has adopted a new actuarial funding method, Entry Age Normal (EAN), that will be implemented effective with the 2007 Valuation after the court-ordered use of the less widely-accepted Projected Unit Credit (PUC) method ends. Importantly, the 2006 Valuation discloses what the impact of the EAN funding method would have been had it been used this year.

Finally, in calendar 2007, the Board will consider a new amortization period for the pay down of the UAL. The 27-year amortization period used in the 2006 Valuation, which is a commonly-accepted amortization period, is required by the Gleason judgment, but that mandate expires after the 2006 Valuation. As with the EAN funding method, for illustrative purposes, the 2006 Valuation discloses different amortization scenarios (e.g., using 15- and 20-year amortization periods).

These are all important changes. However, anyone reading an actuarial valuation must remember that it is just a snapshot of the financial status of a retirement plan taken one day each year.

The fact is that undue focus on the City's retirement plan's short-term results, good or bad, does not serve the best interest of SDCERS, its Members, the City or the citizens of San Diego. By its very nature, a public retirement system's focus is long-term. As a result of the steps taken by the SDCERS Board to implement the recommendations of the actuarial funding study, SDCERS has an actuarially sound program in place to strengthen the City's retirement plan over the long-term.

FREQUENTLY ASKED QUESTIONS

(Revised February 16, 2007 to add Question 10A)

1. **Based on the June 30, 2006 Actuarial Valuation for the City of San Diego (the “2006 Valuation”), what is the City’s Unfunded Actuarial Liability (UAL)?**

As of June 30, 2006, the City’s UAL was \$1.0008 billion. *[See the 2006 Valuation Letter of Transmittal at page i and the 2006 Valuation at page 3.]*

2. **How does the 2006 UAL compare to the 2005 UAL?**

It is \$393.2 million (28.2%) lower than the City’s UAL as of June 30, 2005, which was \$1.3940 billion. *[See the 2006 Valuation Letter of Transmittal at page i and the 2006 Valuation at pages 3-4]*

3. **Why is the 2006 UAL lower than the 2005 UAL?**

The fact that the 2006 UAL decreased by \$393.2 million was due to a number of positive events. Most significant was SDCERS’ investment performance, which was more than 3% higher in fiscal year 2006 than the actuarially-assumed rate of 8%. SDCERS’ superior investment performance in fiscal year 2006 and prior fiscal years, coupled with the new asset smoothing method, produced a gain of \$342.7 million.

In addition, City contributions were higher than what SDCERS expected by \$105.6 million. There was a reduction in some liabilities (\$58.6 million), and liabilities of \$22.8 million in excess of IRC section 415 limits were removed. *[See the 2006 Valuation at page 4.]*

4. **The SDCERS Board of Administration voted to include certain “contingent” liabilities this year. What were they, and what was the impact on the 2006 UAL?**

In September and October 2006, the SDCERS Board voted to include certain liabilities in the 2006 Valuation that historically had not been included in actuarial liabilities. These liabilities were (1) additional benefits payable as a result of the Corbett settlement and (2) payment of the “13th Check” benefit required under the City Charter. By doing so, the City’s 2006 actuarial liabilities were increased by approximately \$112.7 million. *[See the 2006 Valuation at pages 1 and 4.]*

5. **What was the impact of SDCERS using a new asset smoothing method for the 2006 Valuation?**

Asset smoothing methods are used to mitigate the impact that annual investment volatility has on the annual funding cost of a retirement system. Its purpose is to minimize sharp fluctuations in investment returns, which in turn causes sharp fluctuations in employer contribution rates.

Last September, the SDCERS Board adopted the “expected asset” smoothing method for the 2006 and subsequent valuations. The expected asset smoothing method is a more widely-accepted smoothing method that will more effectively achieve the goal of mitigating the impact of market fluctuation on SDCERS’ plan sponsors. The financial impact of moving to the new smoothing method is a one-time experience gain of \$183.8 million. *[See the 2006 Valuation at pages 1, 4 and 25.]*

6. What impact did Judge Barton’s recent legal ruling have on the 2006 UAL?

None. The court’s ruling had no financial impact on the 2006 Valuation because all the benefits left standing by the ruling are already reflected in the 2006 Valuation.

7. What is the City’s 2006 funding ratio?

As of June 30, 2006, the City’s funding ratio, which is the ratio of the actuarial value of assets (after smoothing) over total actuarial liabilities (after smoothing), was 79.9%. *[See the 2006 Valuation Letter of Transmittal at page i and the 2006 Valuation at page 3.]*

8. How does this compare to the City’s 2005 funding ratio?

It is 17% higher. The City’s funding ratio as of June 30, 2005 was 68.2%. *[See the 2006 Valuation Letter of Transmittal at page i and the 2006 Valuation at page 3.]*

9. What is the City’s Annual Required Contribution (ARC) for FY 2008? (This is the amount the City will have to contribute to SDCERS on or after July 1, 2007.)

If the City pays the ARC in full in July 2007, the City’s contribution for FY 2008 will be \$137.7 million (approximately 24% of payroll). If the City pays the ARC evenly throughout FY 2008, the contribution will be \$143.1 million (approximately 25% of payroll). *[See the 2006 Valuation Letter of Transmittal at page i and the 2006 Valuation at page 5.]*

10. How is the City’s FY 2008 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, 2006 of the portion of the employee’s projected retirement benefit assigned to FY 2008. By paying the NC, the City funds the value of benefits in the year to which they are attributable. (City employees also pay a NC contribution, which when added to the City’s NC contribution totals the Plan’s NC.) 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 current amortization period is 27 years, as required by the Gleason judgment. *[See the 2006 Valuation at pages 5 and 33-34.]*

10A. What if a 15-year amortization period had been used to calculate the City's FY 2008 ARC?

Cheiron has prepared a Supplemental Exhibit for the June 30, 2006 actuarial valuation for the City that was prepared assuming the City used a 15-year period for amortizing the unfunded actuarial liability. If a 15-year period had been used to amortize the unfunded liability, the City's FY 2008 ARC would have been \$166.8 million if paid in full as of July 1, 2008. For additional information concerning a 15-year amortization period, please see Cheiron's Supplemental Exhibit to the SDCERS Board of Administration, dated February 7, 2007.

11. What was the market value of SDCERS' Trust Fund on June 30, 2006, and what was the City's portion of this amount?

On June 30, 2006, the market value of the assets in SDCERS' Trust Fund was \$4.226 billion. The City's portion of this amount was \$3.981 billion. *[See the 2006 Valuation at pages 3 and 26.]*

12. How do these amounts compare to the June 30, 2005 market values?

They are 24% higher. The June 30, 2005 market value for the SDCERS' Trust Fund was \$3.412 billion, and the City's portion of the Trust Fund was \$3.205 billion. *[See the 2006 Valuation at pages 3 and 26.]*

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

Between the City's 2005 and 2006 Valuations, the market value of assets had a net increase of approximately \$776 million (24%).

During this period, the City contributed \$271 million to the SDCERS Trust Fund (\$163 million in July 2005 in payment of the FY 2006 ARC, \$108 million of tobacco settlement and additional contributions in June 2006). City employees contributed \$60 million, and DROP participants added \$54 million. (The City's FY 2006 ARC of \$162 million that was contributed in July 2006 will be reflected in the 2007 Valuation.) *[See the 2006 Valuation at page 23.]*

Net investment income was approximately \$400 million and net proceeds from a litigation settlement added \$11 million. *[See the 2006 Valuation at page 23.]*

In addition, in prior actuarial valuation reports DROP and other assets held for certain contingent liabilities were counted separately in the reporting of total Trust Fund assets. SDCERS' Board directed that all assets and liabilities, including contingent liabilities, and DROP assets be included in the calculation of the City's Plan assets, liabilities, UAL and ARC payment. This added \$266 million to the City's total market value of assets. *[See the 2006 Valuation at page 24.]*

Offsetting these additions, SDCERS paid \$286 million in benefits to retired Members. *[See the 2006 Valuation at page 24.]*

14. **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 2006 Valuation at page 37.]

15. **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, 2006 were 12.73%, 14.51%, 9.09% and 10.00%, respectively. Keep in mind that annualized investment returns are close, but not identical, to the actuarial rate of return (e.g., 11.28% for the year ending June 30, 2006) because the actuary includes certain balance sheet transactions that are not included in the investment portfolio. [See the 2006 Valuation at page 26.]

16. **Did SDCERS change the amortization period for the 2006 Valuation?**

No. The Gleason judgment mandates an amortization period for the 2006 Valuation of 27 years. The terms of that judgment end after this year. Although that is a commonly-accepted amortization period, the SDCERS Board will be able to establish a new amortization period for the City's June 30, 2007 Valuation affecting the City's contribution rates beginning July 1, 2008. SDCERS' Board will consider a new amortization period in calendar 2007. [See the 2006 Valuation at page 2.]

17. **What about retiree health care expenses?**

Health care expenses are a separate obligation of the City and are not paid from retirement assets in the SDCERS Trust Fund.

18. **What will the 2007 Valuation look like?**

Looking forward, the City's June 30, 2007 Actuarial Valuation will reflect additional changes in methodologies (e.g., the EAN funding method), possibly a new amortization period, investment results that may be higher or lower than the actuary's assumed rate, the continuing impact of the expected return asset smoothing method, and experience factors involving the City's workforce that cannot be predicted with certainty. But whatever the results of the June 30, 2007 Actuarial Valuation are, they, too, will only be another snapshot of the status of the City's retirement plan on that day.