

POLICE AND FIRE RETIREMENT PLAN

Minutes of the Special Board Meeting

WEDNESDAY

SAN JOSÉ, CALIFORNIA

January 18, 2006

CALL TO ORDER

The Board of Administration of the Police and Fire Department Retirement Plan met at 10:17 a.m., on Wednesday, January 18, 2006, in regular session in the Department of Retirement Services' Conference Room, 1737 North First Street, Suite 580, San José, California.

ROLL CALL

Present:

MARK J. SKEEN, CHAIR

KENNETH HEREDIA, VICE CHAIR

BILL BRILL

MARK BURTON

BRET MUNCY

Fire Employee Representative

Retiree Representative

Civil Service Representative

City Administration Representative

Police Employee Representative

Absent:

DAVID CORTESE

CINDY CHAVEZ

City Council Representative

City Council Representative

ALSO PRESENT:

Edward F. Overton -SECRETARY / DIRECTOR

Aracely Rodriquez -OER

Bill Hallmark -Mercer

Anne Ortiz -CMO

Roger Pickler -Staff

Chistopher Platten -Counsel Local 230

Tamasha Johnson -Staff

Debbi Warkentin -Staff

Susan Devencenzi -City Attorney

Allison Suggs -OER

Maria Olivias -CMO

Jim Spence -AORPF

Robert Diaz -Local 230

Jason Ortez -Local 230

Colleen Hy - "

REGULAR SESSION

ORDERS OF THE DAY

The Chair called the meeting to order at 10:17 a.m.

OLD BUSINESS / CONTINUED ITEMS

Further discussion and approval of results of William M. Mercer's biannual experience study for the period ending 30 June 2005 and approval of actuarial assumptions.

Mr. Hallmark explained that he would go through his report, which is intended to respond to questions from the December meeting. He will be addressing those specifically asked questions then at the end of the meeting he will answer other questions that may come up.

He went into his report by looking at some of the components of the change in member and city contribution rates based on Mercer's recommended assumption changes and to show the math behind it. He has divided them into the economic and demographic changes; as well they have a method change for the amortization method they are proposing. Economic really means the change to the real wage growth and the merit and

longevity wage growth assumption. All the other assumptions fall into the demographic category. The normal cost, which is in terms of dollars/thousands, the change to the wage growth assumption actually reduces the normal cost slightly from about \$63 million down to \$60 million. The demographic assumption changes, which includes the retirement rates, turnover rates, disability incidence, and disabled retiree mortality had another slight reduction to the normal cost dropping it from \$60 million to \$57 million. The total drop from \$63 to \$57 million is split fairly evenly between the two areas of assumption changes. The normal cost is a key component to the contribution rate.

The accrued liability and the actuarial value of assets develop the unfunded accrued liability or it could be a surplus, and in fact in the past it was a surplus. The difference in the accrued liability in the actuarial value of assets, and actuarial value of assets is the five year smoothed value of assets not the current market value. Across the board nothing was changed that affects the actuarial value of assets, so that is the same. The change due to the salary assumption changes had a slight reduction in the accrued liability from \$2.14 billion down to \$2.11 billion. The demographic changes had a slight increase. The result of all the changes is about a \$13 million increase in the accrued liability. The accrued liability represents the value of the benefits assigned to past service, for prior service, the normal cost addresses what happens in the future. The two combined creates a shift of fewer benefits being assigned to the future and more assigned to the past because the accrued liability has gone up and the normal cost has gone down.

The Secretary asked if this is being driven by actual experience or by a retro change in assumptions.

Mr. Hallmark explained that it is the change in assumption; none of this is based on experience. The \$2.14 billion accrued liability is based on all our experience up through July 1, 2005 but using the assumptions from the prior evaluation.

The Secretary stated if we went back to having economic assumptions at \$2.11 billion and changed the demographics and it goes up by \$13, \$14, or \$17 million dollars. Is that then saying that people are going to live longer so you have greater liability?

Mr. Hallmark stated that if they changed the mortality and say people are going to live longer than the value of the benefits they earn to date is larger than we said it was before, this is just a piece of it. There is also an adjust of how many people we think are going to terminate before they retire and accumulate benefits, and we change the turn-over assumption, the disability incidence assumption has an affect on that, and the retirement assumption. All of those things have an affect, not only on the value we assign to the benefits that will be earned in the future but also on the value of those already earned because they are assessing the probability that you will get a certain form of benefit and different pieces are more valuable or less valuable than others. On the economic piece, the reason the salary scale affects the cost assigned to the past, as well as, the future is the cost that's assigned to the past is designed to be based on a level percentage of pay over an employees career and its not based on the actual benefits earned to date. There is no change to the actual benefits earned to date but using that level percent of pay over the career, when we change the payroll growth assumptions that changes how that level works over someone's career, so there is an adjustment to what the actuarial method says you should have in assets for past service but there's no change to actual benefits.

The Secretary asked about a request/desire to determine the impact on liabilities on each individual assumption changes.

Mr. Hallmark said they did not identify each individual assumption change, but if there are specific assumption changes we want to focus on and isolate they could do that. Identifying each one individually, they could do rough estimates but the cost of ferreting out each one individually probably outweighs the value unless there is a specific one selected to focus on.

The Board and *Mr. Hallmark* discussed how our plan got to an added \$17 million in accrued liability, and the prediction of what is going to happen in the future. Mr. Hallmark made an illustration to explain how they arrive at certain assumptions and then the effect from the cost method used.

Mr. Hallmark said the unfunded accrued liability was developed for each of the changes, so it decrease with the wage growth assumption changes and increases with the demographic assumption changes. There is a part of the unfunded accrued liability that is for members cost of prior service, which is an amendment found in the municipal code, it is an adjustment to the rate of about six basis points, so that is tracked separately. The prior experience is everything else of the unfunded accrued liability from experience prior to 7/1/2003. If looked at the 7/1/2003 evaluation and the unfunded accrued liability there and carried forward with the amortization schedule to 7/1/2005 that is the amount there, which doesn't change going across. The new experience is from 7/1/2003 to 7/1/2005, which differs from what was assumed, so it is the piece that gets adjusted with the changes in assumptions. That piece is paid for by the City. This is amortized over 12 years as a level percent of payroll, so with the payroll growth assumption, before any changes that means we were amortizing using a factor of about 10.1 percent. The amortization of the unfunded accrued liability is the unfunded accrued liability multiplied by the amortization factor and that is the current payment on the unfunded liability. When Mercer changed the real wage growth assumption and reduced it that made a minor modification to that amortization factor but we are still looking at 12 years.

The Chair asked what the reasoning was for the prior amendment figure to have gone down to \$126 then up to \$129 and remaining that.

Mr. Hallmark explained that was because the amortization factor went from 10.1 percent to 10.3 percent. The total amount of \$1251 stayed the same. The plan is just working down the amortization and paying it off so it is getting smaller each time but that \$1251 does not change but because the payroll growth assumptions were changed it changes the amortization factor. That results in a slightly higher payment because that is so small it doesn't affect the rate. What Mercer has proposed in terms of the amortization method change is to spread the new experience over 20 years and the issue was that currently the plan is at 12 years and as that time period shortens, any gains and losses are going to be amortized over a shorter and shorter period, so it will create a lot of volatility in the City's contribution rate. Mercer suggested to continue paying the prior stuff off on the schedule we have, but may want to look at a longer period for the new pieces.

The member contribution is calculated as 3/11ths of the normal cost plus the payment on that prior amendment base, so you can see with these changes the member contribution goes from about \$17.3 million down to about \$15.7 million. The City contribution is the other part of the normal cost plus all of the unfunded accrued liability except the prior amendment piece. It goes down from \$48.7 to \$44.4 million, the economic and demographic assumption changes drop from \$48.7 to about \$46 million, and then lengthening the amortization period reduces it by another \$1.5 million. So the contribution rates are the dollar amounts divided by the payroll from the evaluation. The evaluation payroll is the estimate of the covered payroll for the year commencing 7/1/2005.

The Board, *Ms. Devencenzi*, and *Mr. Hallmark* discussed the reasoning and background in estimating future payroll cost.

Mr. Hallmark started discussing the amortization method recommendation, which is to amortize new gains and losses from each evaluation date over 20 years, so we would amortize that piece this evaluation over 20 years, then in two years when we did another valuation that amortization would be down to 18 years, but we would amortize the new gains and losses between 7/1/2005 and 7/1/2007 over 20 years, so you end up with a

variety of amortization bases being amortized over different time periods. The rationale behind that is to help stabilize rates but to make sure that the unfunded accrued liability is paid off. A question that was raised is how that compares to doing it over a 16 year or 30 year amortization and the end cap of that and to discuss the GASB parameters for these methods and what other plans are doing. In looking at the losses since the last evaluation there are \$47 million in losses. One key point put out to looking at the amortization method was whether or not the interest payment in the first year was being made on the unfunded accrued liability. The interest at 8.0 percent on that \$47 million is \$3.78 million, so you wanted to keep that at \$47 million you would have to pay \$3.78 million in interest charges each year. If you look at a 16 year amortization period requires a first year amortization payment of about \$3.9 million, \$3 million for 20 years, and \$2.6 million for 30 years. The net principal payment is found by subtracting out the interest charge, so the only one that makes a positive payment on the principal is the 16 year, it makes a small payment. Now because these are set up as a level percent of pay and the assumed pay grows at 4 percent per year, each year's payment is larger, thus paying down the principal more and more. The change in contribution rate over what we recommended is a 27 basis points increase if we go to 16 years and a 34 basis points decrease if we go to 30 years. The concept of amortizing that change is that some years we will have a gain and some years we will have a loss, so in this particular period we had a loss. If one was to think in terms of recognizing a gain or loss immediately, and in this case the \$34 million, you would have to think does that help to stabilize the fund and system as a whole, and make sure the benefits are funded well. It makes sense to amortize that over some period and every plan amortizes it over some period, as we too do. The question then becomes how long of a period should it be amortized over and that is where we are balancing the stability versus the annual changes.

The Board and *Mr. Hallmark* discussed the amortization period, the Board's responsibility to the plan, reasons to change the amortization period, different scenarios using various amortization schedules, and the history of the plans gains and losses, as well as, the current way of amortizing.

Mr. Hallmark continued in his report addressing the plan's maturity compared to other governmental plans. There are a number of ways to talk about the maturity of a plan and there are a limited number of statistics that are available to compare to, so what we have done is suggested to measure the maturity of the plan is really to observe the trend and the ratio of actives to annuitants. The plan is paying for all the benefits based on payroll contributions over actives and the benefits that are currently being paid are the annuitants. When the plan is first established, it has only active members and no annuitants. As it matures, the ratio of actives to annuitants declines until an equilibrium is reached. In 2004 survey of Public Funds, there are 103 different plans included, and the ratio is declining gradually from 2001 to 2004. This plan is following a similar path and the maturity level is about average.

Lunch break 11:36 a.m. – 12:17 p.m.

Mr. Hallmark continued regarding our plan's funding percentage of 98 percent and the acceptable funding percentage for the plan. Funded percentage refers to the smoothed value of assets, not the market value. If a plan is 100 percent funded it means that it has enough assets to pay the benefits earned today or a bit more based on the actuarial method, and if the investment returns that we assumed are realized and all other assumptions are met. When assumptions are set the aim is to use our best estimate to predict what will happen in the future, if you focus just on investments, most of the gains and losses are going to be driven by the investment return. Since actuarial assumptions are a best estimate, there is a 50 percent chance experience will be better than predicted and a 50 percent chance it will be less than predicted. As a result, a funded ratio of 100 percent indicates that there is a 50 percent chance the plan has enough assets to pay benefits earned to date and a 50 percent chance additional contributions will be required. 100 percent funded does not mean that

your plan is in the clear. A 98 percent funded level is very close to the 100 percent target.

Mr. Hallmark discussed Mercer's recommended retirement rates, which are based on age and compared them to the rates used by CalPERS, which are based on age and service. The CalPERS rates for members with 25 years of service are an appropriate comparison and the recommended rates are very similar to those used by CalPERS. There would be problems looking at sufficient data for rates on years of service for those eligible for unreduced benefits, which vary based on their years of service as well as age.

The Vice-Chair asked a question of concern about the basis, particularly the demographic and economic assumptions lack of consistency between using experience to develop those assumptions and using something else to develop those assumptions.

Mr. Hallmark responded that the aim is to develop the best estimate of future experience, so the first question they ask is what relevance does past experience have to prediction of future experience. In most cases it is the best indicator, so particularly if looking at turn over rates, retirement rates, those things would be our best indicator. However, if a fundamental change was made to the organization or the plan the future rates might be completely different than the past. For most of the demographic pieces the past experience was looked at as the prime indicator of what the rates should be. An issue with that though is does our plan have sufficient experience to be a credible predictor of what the future will be, but that is a more difficult issue when the incident rates are low, such as mortality. When you do mortality study if you have two thousand lives you are looking at you can get rates bouncing all around compared to if you have two hundred lives. So when you are looking at those sorts of rates, we benchmark against what other standards are out there and certainly in terms of the shape of the expectation. In looking at our disability rates, the overall disability incidence rate was from experience but that is spread over various ages up to where they saw a variance from standard tables and that is spread over those years, so that the pattern was similar to what is found in other disability studies. Similarly on the retirement rate things are grouped for the study into five year increments to get enough experience to really get a rate. Then the rate is analyzed and saw no reason why the rates would be different between those bands. If you looked at the actually data in the experience study the rate would have bounced all over. For disabilities they increase with age so they drew a line that fit that pattern to guide them using a chart with similar data, but it is not applied to the actual Police & Fire group. There is a multitude of factors, as it is too difficult to look at everything individually, so actuaries use an external chart to grasp the curve of the data to get an idea of where to set the level. That is the demographic side now looking at the economic side of this there is a blend at looking at the past experience and looking to the future based on the financial economics theories. Basically, looking at the markets today determine built-in factors, such as inflation. The markets tells us that the consensus representation of what the future holds in terms of some basic economic factors, we use those as opposed to historical experience because it is not indicative of future experience because part of that is that economic conditions play a role in what future experience will be and the financial theory says that the market expectation is what buried in market prices. In this study for inflation, the way we looked at the market prices is there are treasury bonds on a nominal basis and there are ones that are adjusted for inflation so they both have the same credit quality and the difference in the yield is the expectation of inflation over that period of time, so that was a basis for the inflation assumption, which doesn't necessarily bear any relation to what recent experience has been but market consensus of the expectation.

The Secretary asked if Mercer deals with the investment arm to develop market expectations for the real rate of return assumptions.

Mr. Hallmark stated that they do, as they have the same source that investment managers use.

The Secretary asked do you give weight to our particular asset allocation after you have gotten these market returns.

Mr. Hallmark stated they get the market returns based on asset class and put the allocation into a tool called the portfolio return calculator that gives them the expected return and the variance will show over 20 or 30 year time frame what can be expected. Same tool investment consultant would use.

The Vice-Chair stated that there are confidence levels throughout experience study but no confidence levels for any economic data. And asked two years ago at what point you change your investment assumptions.

Mr. Hallmark explained that the confidence intervals would apply when looking at the past experience, so inflation was developed by looking at treasury yield. Assumptions developed by looking at our asset allocation and the expectations in the different asset classes and develop a median and standard deviation of those returns. The median is shown in the vertical report in the study and the expectation was 8.01 percent. It says essentially we think over a long period you have a 35 percent chance of getting a return of 6.79 percent or less, and also think have a chance of getting 9.04 percent or greater. The 50th percentile is 7.91 percent. The assumptions can be changed to 7.91 percent but that rate will change every year, but in actuarial assumptions we choose not to change that rate until it varies on way or the other in a significant way and required with Mercer to change it if outside the 35th or 65th percentile.

The Board and *Mr. Hallmark* discussed the review of the SRBR and the effect of the rate of return.

(M.S.C. Heredia/Brill) to defer this item to February. Motion carried 5-0-2.

Authorization to Mercer, Board's actuary, to produce GASB 43/45 calculations for retiree medical for an amount not to exceed \$40,000.

(M.S.C. Heredia/Brill) to defer this item to February. Motion carried 5-0-2.

ADJOURNMENT

There being no further business, at 1:00 p.m., **The Chair** stated the meeting would be adjourned.

MARK J. SKEEN, CHAIR
BOARD OF ADMINISTRATION

ATTEST:

EDWARD F. OVERTON, SECRETARY
BOARD OF ADMINISTRATION