

February 25, 2010

Mr. Gary Amelio, Executive Director  
San Francisco Employees Retirement System  
30 Van Ness Avenue, Suite 3000  
San Francisco, CA 94102

**Re: *City Controller's Request for Cost Estimates***

Dear Gary:

As requested, we are estimating the cost impact of the proposed plan changes forwarded by the City Controller. This letter provides estimates for the following plan changes which we understand would be effective only for new members hired on or after January 1, 2012.

- Change from two-year to three-year final average compensation
- Establish maximum cap on pensionable compensation with no employee or employer contributions required on covered pay above the maximum
- Reduce maximum pension percentage from 90% to 75% for Safety
- Eliminate or modify vested termination benefits for Miscellaneous members

Since these changes only affect new hires, the cost estimates are based on an expected change in the normal cost rate assuming the demographic characteristics of new hires are identical to the demographic characteristics of the current plan population. The impact of these cost savings will only be fully realized when new employees replace all current employees.

Estimates for the other plan changes requested by the City Controller will follow as soon as they are available.

### **Three-Year Final Average Compensation**

Proposition D, passed by the voters in June, 2010, changed benefits from being based on one-year final average compensation to two-year final average compensation for members hired after June 30, 2010. The proposed amendment would further change benefits to be based on three-year final average compensation for members hired after December 31, 2011.



The table below compares the City normal cost rate from the July 1, 2010 valuation to the expected normal cost under Proposition D and the proposed Charter amendment.

| <b>Member Group</b> | <b>July 1, 2010<br/>Valuation</b> | <b>Proposition D</b> | <b>3-Year Final Average<br/>Compensation</b> |
|---------------------|-----------------------------------|----------------------|--|
| Police              | 18.57%                            | 16.15%               | 15.43%                                       |
| Fire                | 24.66%                            | 22.10%               | 21.23%                                       |
| Miscellaneous       | 8.03%                             | 7.62%                | 7.29%  |
| <b>Composite</b>    | <b>10.40%</b>                     | <b>9.60%</b>         | <b>9.19%</b>                                 |

It should be noted that the Proposition D estimate differs from our prior estimate because the prior estimate was based on the July 1, 2009 actuarial valuation data and assumptions. The estimate shown above is based on the July 1, 2010 actuarial valuation data and assumptions.

### **Maximum Cap on Pensionable Compensation**

Currently, there is no limit to pensionable compensation. Under the three alternatives considered, a limit would be established for any member hired after December 31, 2011 equal to either the Internal Revenue Code Section 401(a)(17) limit (\$245,000 for 2011), \$200,000, or \$135,000. Each of these limits is assumed to be adjusted each year for inflation using the valuation's inflation assumption of 3.5% and the rounding methodology used for Internal Revenue Code Section 401(a)(17).

Under these alternatives, the normal cost rate barely changes at all because the reduction in future liabilities (the numerator of the normal cost rate) is largely offset by the reduction in future pensionable pay (the denominator). However, with the normal cost remaining the same, but applied to a lower payroll, over time (as new hires exceed the limits) there will be cost savings. The table below shows the percentage reduction in the current normal cost dollars assuming these limits applied to the current population of active members.

| <b>Member Group</b> | <b>401(a)(17) Limit</b> | <b>\$200,000 Limit</b> | <b>\$135,000 Limit</b> |
|---------------------|-------------------------|------------------------|------------------------|
| Police              | -0.11%                  | -0.25%                 | -1.96%                 |
| Fire                | -0.05%                  | -0.17%                 | -2.65%                 |
| Miscellaneous       | -0.03%                  | -0.14%                 | -2.31%                 |
| <b>Composite</b>    | <b>-0.04%</b>           | <b>-0.15%</b>          | <b>-2.30%</b>          |

Since this provision only applies to new hires, it is likely that it will not have a measurable impact for some time. Eventually, however, the impact is likely to be even larger than the amounts shown above if the compensation limit is adjusted only for inflation as salaries typically rise faster than inflation. The size of the ultimate impact will depend on how much salary increases exceed inflation.

**Maximum Safety Benefit Percentage**

Under current plan provisions, safety members cannot receive a benefit greater than 90% of final compensation. The table below compares the City normal cost rate from the July 1, 2010 valuation to the expected normal cost under Proposition D and applying a 75% of final average compensation limit for safety members.

| <b>Member Group</b> | <b>July 1, 2010<br/>Valuation</b> | <b>Proposition D</b> | <b>Maximum 75% of<br/>Final Average<br/>Compensation</b> |
|---------------------|-----------------------------------|----------------------|--|
| Police              | 18.57%                            | 16.15%               | 13.94%   |
| Fire                | 24.66%                            | 22.10%               | 20.23%   |
| Miscellaneous       | 8.03%                             | 7.62%                | 7.62%  |
| <b>Composite</b>    | <b>10.40%</b>                     | <b>9.60%</b>         | <b>9.22%</b>   |

It should also be noted that this change could result in an increase in the retirement rates of safety members who have at least 25 years of service and have attained age 55. While we have made no estimate of the impact of changes in retirement rates, we would anticipate earlier retirements offsetting a portion of the cost savings attributable to the 75% cap.

**Modify or Eliminate Vested Terminated Benefit**

Current Miscellaneous members with 5 or more years of service when they terminate employment prior to retirement receive a benefit equal to the actuarial equivalent of twice the member’s accumulated contributions with interest as of their retirement date.

Under the proposal to eliminate the vested termination option, any Miscellaneous member who terminated employment before eligibility for retirement would only receive a refund of their member contributions with interest.

Under the modified vested termination proposal, a member terminating employment prior to eligibility for retirement would receive a refund of their member contribution with interest plus a matching amount from the City based on the number of years of service completed as follows:

| <b>Service</b> | <b>Match</b> |
|----------------|--------------|
| 0 – 10         | 0%           |
| 10 – 20        | 50%          |
| 20 or more     | 100%         |

The table below compares the City normal cost rate from the July 1, 2010 valuation to the expected normal cost under Proposition D and the expected normal cost rate modifying or eliminating the vested termination benefit.

| <b>Member Group</b> | <b>July 1, 2010<br/>Valuation</b> | <b>Proposition D</b> | <b>Modify Vested<br/>Termination<br/>Benefit</b> | <b>Eliminate<br/>Vested<br/>Termination<br/>Benefit</b> |
|---------------------|-----------------------------------|----------------------|--|---|
| Police              | 18.57%                            | 16.15%               | 16.15%   | 16.15%  |
| Fire                | 24.66%                            | 22.10%               | 22.10%   | 22.10%  |
| Miscellaneous       | 8.03%                             | 7.62%                | 7.17%  | 6.86%   |
| <b>Composite</b>    | <b>10.40%</b>                     | <b>9.60%</b>         | <b>9.23%</b>                                     | <b>8.98%</b>  |

### Data, Methods and Assumptions

This analysis is based on the data, methods and assumptions described in the July 1, 2010 actuarial valuation report. To estimate the ultimate impact of the changes, we compared the normal cost of the current population under the current provisions to the normal cost of the same population under the proposed provisions assuming they had always been covered under the proposed provisions. Essentially, we assume that the plan population when all active members are covered by the new provisions is the same demographic mix (age, lengths of service, etc.) as the current population.

These estimates are based on our understanding of the plan changes and the data, assumptions and methods all as described above. Differences between our assumptions and the actual future experience of the plan may produce different results.

If you have any questions, please let us know.

Sincerely,  
Cheiron



William R. Hallmark, ASA, FCA, EA, MAAA  
Consulting Actuary

cc: Gene Kalwarski  
Jay Huish  
Ray Lane  
Anne Harper