

# The Evolution of the SDCERS Funding Deficit

## I. The Snake in the Garden of SDCERS: the seductive concept of “Surplus Earnings”

The evolution of the SDCERS funding shortfall began in 1980 with the adoption by the San Diego City Council of a provision that allocated 50% of the annual returns from SDCERS assets – to the extent those returns exceeded the SDCERS actuary’s assumed rate of return – as a supplemental lump-sum payment to retirees.<sup>104</sup> Under this provision, cash returns that exceeded the actuarial rate in a given fiscal year were defined as “surplus earnings,” half of which was distributed to retirees as what became known as a “13<sup>th</sup> Check,” paid on an annual basis.<sup>105</sup>

The remaining 50% of surplus earnings went to the “Employer Contribution Reserve” – essentially an accounting entry representing the residue of aggregate contributions to the system not allocated to other reserves<sup>106</sup> – “for the sole and exclusive purpose of reducing retirement system liability.”<sup>107</sup> “Counted” for actuarial purposes within System assets, the Employer Contribution Reserve provides a source of funding for all System liabilities. It is not available to offset or reduce the City’s required annual contributions.<sup>108</sup> Thus, under this provision of the

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<sup>104</sup> San Diego, Cal., Ordinance 0-15353 (N.S.) (Oct. 6, 1980).

<sup>105</sup> SDCERS accounts for its operations on an accrual basis under GASB standards. The various benefits paid from “surplus earnings,” however, are calculated on a cash basis. As provided by Municipal Code ch. 2, art. 4, div. 1, § 24.0103, “investment earnings received,” from which “surplus earnings” are derived, are defined as:

all interest received (net of interest purchased) on notes, bonds, mortgages, short-term money market instruments, and savings accounts; cash dividends received on stock investments; and all realized gains and losses from the sale, trade, or conversion of any investments of the Retirement System.

This accounting anomaly would seem to require an annual truing up between the cash-basis calculations done to determine, for example, the interest credited to various reserves, and the way in which System returns are allocated on an accrual basis. It appears this is not done. The primary difference between the two approaches, however, is the treatment of unrealized investment gains and losses, which can be predicted to wash out over time as assets are turned over.

<sup>106</sup> SDCERS requires three basic reserves for operational accounting purposes. The first is “the Employee Contribution Reserve,” which represents the total amount contributed by City employees, with interest thereon, minus outflows to fund individual pension benefits. The second is the “Retiree Contribution Reserve.” Whenever an individual retires from City employment, an amount representing the (actuarially calculated) present value of the liability to fund that individual’s retirement benefits is added to this reserve and offsetting deductions made to the employer and employee contribution reserves. The third reserve, as mentioned, is the “Employer Contribution Reserve.” It receives any amounts generated by the System not committed to any other use. If earnings from fund assets are insufficient in any given year to pay required expenditures of the System, such as SDCERS’ administrative costs or interest on the employee and retiree reserve accounts, the amount is debited against the Employer Contribution Reserve to balance the System’s books. These three reserves are not separately funded, but rather are bookkeeping categories for internal accounting purposes. As described below, however, additional reserves have been created by SDCERS, often reflecting additional benefits granted by the City. These reserves have affected the allocation and distribution of SDCERS assets.

<sup>107</sup> Former Municipal Code ch. 2, art. 4, div. 2, § 24.0907.1(b).

<sup>108</sup> *Claypool v. Wilson*, 4 Cal. App. 4th 646 (1992).

Municipal Code, half the “surplus earnings” generated by the system in any given fiscal year were to be distributed to retirees and the other half retained to support the fiscal soundness of the system. Prior to the adoption of this measure, all cash returns generated by SDCERS assets went to deepen system funding.<sup>109</sup>

This provision responded to a serious problem of the City’s retiree population, but in a manner characterized by the fiscal shortsightedness that, over the following twenty years, was to become a recurrent theme in the City’s dealings with SDCERS. It responded to the bleak financial situation faced by many City retirees at the beginning of the 1980s. Retirees of that period received substantially lower pension benefits than do employees retiring today. The factor that, when multiplied against years in service and highest one-year salary, determines the basic annual benefit was then approximately 1.5%, compared to 2.5% (for general members) today. Moreover, the purchasing power of even this modest allowance had been eroded by the double-digit inflation of the late 1970s. By earmarking half the System’s “surplus earnings” to supplement the income of its retired workers, the Council sought to address this situation without depleting the City’s operating funds.

In the short-term, this approach worked as intended. Retirees received additional financial support, with no recognized cost to the City. And because the 13<sup>th</sup> Check was to be paid wholly from “excess” cash generated by SDCERS investments, rather than the draw-down of actuarially “counted” assets, the provision of this benefit did not *immediately* increase the City’s required contributions to the System. Thus, it looked very much as if this measure did no more than distribute investment windfalls to needy retirees. This view, unfortunately, was based on a fundamental misunderstanding of the actuarial concepts that underlie the funding of pension systems, public and private.

A pension system derives its ability to pay benefits from three sources: employer contributions, employee contributions and earnings generated from such contributions when retained within the system and productively invested. In determining the level of employer and employee contributions necessary to achieve the goal of “generational equity” in a pension system, a critical component is the assumed rate of return on fund assets. The greater that rate, the less must be contributed by system participants to fund projected retirement benefits on a basis that remains stable over time as a percentage of payroll. Obviously, no one can predict

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<sup>109</sup> Municipal Code ch. 2, art. 4, div. 9, § 24.0907.1. As initially enacted, however, this section provided that all residual amounts were to be credited to an “Advance Reserve Account,” to be used solely to reduce future employer contributions to the System. Ordinance 0-9620 (July 1, 1967). It appears that before the enactment of that ordinance other distributions were made from surplus earnings. For example, excess earnings for FY 1965 were divided evenly between the City (reducing its contribution to the System) and the accounts of individual members of the System (a benefit only to those who left the System before retirement or the families of those members who died before retirement). See Letter from Edward T. Butler, City Attorney, to Ralph W. Kausch, Retirement Officer, SDCERS (Feb. 14, 1966). In that letter, the City Attorney recommended increasing the assumed rate of return on fund assets to reduce future contributions from both the City and members of the System.

with certainty the future returns that will be generated by any particular category of assets. Projected rates of return, like many other actuarial calculations, are educated guesses derived from historical experience. They recognize that market performance will vary significantly from year to year but assume that returns from specific asset categories will average out over time at close to historical levels. This, of course, means that above-average returns in some years will offset below-average returns in others.

The surplus earnings concept ignores this long-term dynamic of actuarial projections. It evaluates returns on a year-by-year basis and treats all cash generated by system assets (beyond assumed rates of return) as free money. This, of course, flies in the face of the basic premise of actuarially assumed returns: they are rarely met for any individual year, but are expected to average out over time to approximate the projections. Therefore, the concept of “surplus earnings” is a misnomer. Unless and until it can be demonstrated that the actuary’s projections are unrealistically conservative, all earnings are necessary to support the long-term viability of the system – none are truly “surplus” or “excess.”<sup>110</sup>

Eventually, the bill comes due in the form of additional required contributions. The diversion of amounts that would otherwise be added to system assets increases the gap between those assets and the system’s projected liabilities: in actuarial terminology the “Unfunded Actuarially Accrued Liability” (or “UAAL”). An amount calculated to amortize the UAAL is a component of the “actuarially required contribution” (“ARC”) that must be paid each year by the plan sponsor (here the City) to avoid a funding shortfall. Thus, any increase in system underfunding must be paid back (with interest) by the plan sponsor over the amortization period of the UAAL. *Any diversion of earnings from system assets should therefore be seen as a financing arrangement, requiring repayment over time.*<sup>111</sup>

The dangers inherent in treating surplus earnings as a windfall were eventually pointed out by a number of people. For example, SDCERS Retirement Administrator Lawrence Grissom advised the board in April 2002: “[I] believe there has come a perception over the years that

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<sup>110</sup> As a legal matter, the use of surplus earnings to pay various contingent benefits is also dependent on the view that these funds, until designated as “inside” System assets by the pension board, are not necessary for the actuarial soundness of the System. See *Claypool v. Wilson*, *supra* note 98. This, too, contains an element of fiction in that it fails to recognize that projected returns on fund assets are fundamental to the sound funding of any pension system.

<sup>111</sup> The exception to this rule is when a system’s investment returns exceed projections on a sufficiently consistent basis that it accumulates more assets than it will need to pay all of its obligations as they come due. SDCERS achieved a funded level above 100% only once in its history – 105% at June 30, 2000 – and that number was adjusted downward to 97.3% when the SDCERS Board decided to recognize, during that fiscal year, the liability to the System represented by the settlement of the *Corbett* litigation, discussed below. For many years, however, SDCERS’ returns were, on average, higher than the actuarially assumed rate. For example, in the decade prior to 1992, its returns averaged over 14%. This gave rise to a widely-held view that SDCERS would continue to exceed the assumed rate of return on a regular basis.

earnings are cash in pocket, which is not the case.”<sup>112</sup> During the same month, fiduciary counsel to the SDCERS Board opined:

Defining Surplus on a cash basis leads to draining off liquid assets and reducing future earning power. It also undercuts actuarial assumptions about earnings. An assumption of earnings is based on expected averages over a long period of time. By draining off cash in good years, the structure makes it harder to meet the long-term earnings assumption.<sup>113</sup>

San Diego is far from unique in its embrace of the view of surplus earnings as a budgetary free lunch. According to Gary Caporicci of Caporicci & Larson and Lawrence Grissom, the SDCERS administrator, many other municipalities nationwide have used surplus earnings to fund benefits that otherwise would come out of their general budgets (or not be granted). For example, the City of Fresno, California and the County of San Diego, California both subscribe to this practice. The California Civil Code has also recognized this concept, although in statutes not applicable to the City of San Diego.<sup>114</sup> If the benefits funded from “surplus earnings” are carefully limited and the assumed market returns conservative, the damage to the actuarial soundness of a system from this skimming of earnings may be minimal. With San Diego, however, serious problems arose when benefit levels escalated – in part as the result of successful litigation brought by System members – while measures were adopted that allowed the City to make annual contributions at a rate less than that calculated by the System actuary to fund the annual cost of the City’s plan (the ARC).

## II. The Andrews litigation

The initial use of surplus earnings to fund a System benefit – here the 13<sup>th</sup> Check – was flawed for another reason. The measure failed to place any limits on the amount of the annual payment to retirees, apparently from the assumption that surplus earnings generated in any single year would be modest. This expectation quickly proved erroneous. The amount of surplus earnings jumped from \$0.6 million at June 30, 1982 to \$6.9 million at June 30, 1983. The Board, after consultation with its actuary, enacted a rule capping the amount that could be distributed annually through the 13<sup>th</sup> Check at \$30 for each creditable year of City service. This resulted in

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<sup>112</sup> Minutes of SDCERS Board Meeting, at 28 (Apr. 19, 2002). SDCERS minutes are not the official record of its deliberations, which is, instead, the videotapes of its meetings.

<sup>113</sup> Letter from Constance M. Hiatt, Hanson Bridget Marcus Vlahos and Rudy (“Hanson Bridgett”), to Loraine E. Chapin, General Counsel, SDCERS (Apr. 16, 2002). This theme was also taken up by the SDCERS actuary, Rick Roeder and Board member Diann Shipione. *See* Letter from Diann Shipione to P. Lamont Ewell, Assistant City Manager, City of San Diego, at 1-2 (Dec. 31, 2002).

<sup>114</sup> *See* former Ca. Gov. Code § 20132, added by Stats 1982, c. 330, at 1621, § 13, and Cal. Gov. Code § 20816 (c).

a distribution for that year of approximately \$1.4 million. The remaining \$5.5 million of surplus earnings was placed in a reserve for unspecified future benefits and “contingencies.”<sup>115</sup>

SDCERS members responded with a lawsuit, claiming that the Board had exceeded its authority in declining to distribute the full 50% of FY 1983 surplus earnings to retirees.<sup>116</sup> After the plaintiffs prevailed at the trial court level and the City appealed, a settlement was reached under which the City agreed to certain benefit enhancements and paid \$9.7 million to members of the plaintiff classes, but succeeded in retaining a modified version of the cap. The 13<sup>th</sup> Check remains in the Municipal Code as a benefit to be paid annually out of surplus earnings, when they are sufficient for this purpose.<sup>117</sup> It has subsequently been joined by other contingent commitments of surplus earnings, arranged in a hierarchy referred to as the “Waterfall.”<sup>118</sup> These other uses of surplus earnings, including the payment of healthcare premiums and cost of living increases, each discussed in detail below, are paid only to the extent realized cash earnings from the System exceed the amount necessary to pay interest (at a rate set by the Board) on the System’s basic reserves: the Employer, Employee and Retiree Contribution Reserves.

As a contingent benefit, the 13<sup>th</sup> Check is not included in actuarial projections of the System’s long-term liabilities and therefore not factored into the annual contribution rates required from the City and active employees. From FY 1980 through FY 2002, this benefit absorbed approximately \$60 million from SDCERS earnings (without compounding). In FY 1997, the SDCERS Board set aside a reserve of \$3,500,000 (taken from FY 1996 surplus earnings) to fund the 13<sup>th</sup> Check benefit in years when surplus earnings prove insufficient. This reserve is carried outside System assets. By reducing System assets without decreasing projected liabilities, its creation increased the gap between assets and liabilities and consequently the size of the UAAL. Unlike certain other reserves, it was not credited with interest at the actuarially assumed rate, but did receive a share of the System’s realized gains from asset sales.

In FY 2003, the System was unable to fund the 13<sup>th</sup> Check from that year’s surplus earnings. Responding to pleas from retirees, the City Council approved the application of the

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<sup>115</sup> The Board enjoys the authority under the Municipal Code to create “such reserves as the Board deems appropriate” Municipal Code ch. 2, art. 4, div. 15, § 24.1502(a)(3). This does not provide it with discretion to use System earnings in any manner it deems appropriate, as discussed below.

<sup>116</sup> *Andrews v. City of San Diego, Board of Administration of the San Diego City Employees’ Retirement System* (San Diego County Super. Ct.) (No. 515699).

<sup>117</sup> Municipal Code ch. 2, art. 4, div. 15, § 24.1502(a)(6). If the surplus available for this purpose in a particular year is less than \$100,000, no payment is required by the Code for that year and the surplus, if any, is rolled into a reserve. In such later year as the reserve exceeds \$100,000, the benefit again becomes payable.

<sup>118</sup> Municipal Code ch. 2, art. 4, div. 15, § 24.1502.