



MEMORANDUM

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To: Boards of Administration
 Police and Fire Department Retirement Plan
 Federated City Employees' Retirement System

Date: August 27, 2018

Subject: Proposed Reclassification of Tier 2 Service Ordinance

Under cover of its Memorandum dated July 23, 2018, the City's Office of Employee Relations has forwarded for the Boards' comment and recommendations a draft Ordinance which is intended to provide for the cost of reclassifying certain rehired Tier 1 employees' Tier 2 service time as Tier 1 time. These members are referred to in the Memorandum and proposed ordinance as "Reclassified Tier 1" members. Generally speaking, the benefits associated with Tier 1 service in the City are more advantageous to members than Tier 2 service, and accordingly are more costly. By reclassifying certain members' Tier 2 time as Tier 1 time, the associated increase in benefits creates an unfunded liability in the retirement plans, since higher Tier 1 contributions were not collected on that service time.

The proposed ordinance deals with who shall be responsible for paying that unfunded liability, on what terms and over what period of time. A copy of the OER Memorandum, the attached Side Letter agreements between the City and its bargaining units, and the proposed Ordinance accompany this Memorandum.

In summary, the proposed ordinance would require Reclassified Tier 1 members to "pay the entire cost, including any unfunded liability, of the transition from Tier 2 to Tier 1 membership." *See* proposed ordinance, section 3.28.200.A.1.ii (Federated); 3.36.410.A.1.ii (Police & Fire). All such members would pay the same contribution rate towards that cost, but each individual member would pay that rate for a shorter or longer period than others, depending on the actual length of his or her Tier 2 service time being reclassified. It is proposed that Reclassified Tier 1 members would sign legally binding contracts with the City requiring them to pay their individual amounts in full, during service or shortly following their separation from service. If the member fails to pay the balance due, "the Reclassified Tier 1 member shall be reclassified as a Tier 2 member and only receive benefits attributable to Tier 2 membership." *See* proposed ordinance, section 3.28.700.E (Federated); 3.36.720.E (Police & Fire).

Based upon our analysis of OER's Memorandum, the Side Letter agreements and the proposed ordinance, and communications with OER and with the plans' actuary, Cheiron, we have the following observations and recommendations on the proposed ordinance for the Boards' consideration:

1. For what cost will members be responsible?

The first paragraph in the “Analysis” section of OER’s Memorandum states that the unfunded liability associated with reclassifying Tier 2 service as Tier 1 service “will be split between the employee and the City on a 50/50 basis.” The proposed ordinance, however, requires the affected employees to pay the “entire cost, including any unfunded liability” of the transition. Upon inquiry, OER indicated that “the entire cost” refers only to the 50% portion of the cost to be borne by the Reclassified Tier 1 members. However, we find nothing in the existing or proposed language that makes this distinction clear. The distinction is certainly material to the terms the parties bargained. We recommend that the proposed ordinance clarify this point before the City Council votes to adopt it.

2. How will the “unfunded liability” for each member be calculated?

The plans’ unfunded actuarial liability (“UAL”) is calculated annually, and each year thereafter gains and losses occur based on experience changes (*e.g.*, investment performance, mortality rates, inflation, salaries and headcount) and methodology changes (*e.g.*, assumed rate of return, discount rate, amortization periods, asset smoothing). The UAL attributable to the benefits earned for a particular year of service fluctuates over time.

We find nothing in the proposed ordinance that would establish how the UAL attributable to the reclassification of Tier 2 service as Tier 1 service for affected members is to be calculated. Upon inquiry, we are told by the actuary and OER that as of the effective date of the ordinance, they anticipate calculating a set UAL amount attributable to each affected member, which UAL amount will be locked in and will not fluctuate in the way that the plans’ remaining UAL fluctuates. Any future gains and losses would be attributable solely to the City, thereby shifting to the City the risk of an increased UAL.¹ In that case, the members would not be “pay[ing] the entire cost, including any unfunded liability, of the transition from Tier 2 to Tier 1 membership.”

The proposed ordinance is silent on this subject. If the City is going to have exposure to potential additional unfunded liabilities attributable to the reclassification of Tier 2 service as Tier 1 service, that would be inconsistent with both a 50/50 split of such UAL or the members bearing “the entire cost” of such UAL. Whichever is the parties’ intent, the ordinance should not be silent on this point. The ordinance is part of each plan’s formal plan document. Ambiguity in the plan document should be avoided, particularly where the issues are known before the document is finalized. We recommend that the proposed ordinance clarify this point before the City Council votes to adopt it.

¹ Cheiron advises that changes in the applicable interest rate, however, will be reflected in the length of the amortization periods applicable to each member. This also does not appear in the language of the proposed ordinance.

3. What is the true consequence of a Reclassified Tier 1 member's failure to repay his or her obligation?

The proposed ordinance mandates that affected members repay their individual obligations before 60 days following their separation from service. *See* proposed ordinance section 3.28.700.E (Federated); 3.36.720.E (Police & Fire). Failure to timely pay the obligation would result in member being "reclassified as a Tier 2 member and only receiv[ing] benefits attributable to Tier 2 membership under this plan." *Id.*

On its face, the proposed language would appear to cause a confiscation of the value of any *previous* Tier 1 service earned by a member who separated from service while a Tier 1 member, came back as a Tier 2 member, and is now being reclassified as a Tier 1 member for all years of Tier 2 service. For the prior Tier 1 service, the member presumably paid Tier 1-level contributions. If the Reclassified Tier 1 member who fails to fully repay his or her reclassification obligation is to lose *all* Tier 1 service credit, this would appear to cause a forfeiture of (a) the value of that prior Tier 1 service, (b) a portion of the contributions paid for that service, and (c) any reclassified Tier 1 service for which the member had already paid before separation.

Upon inquiry, OER advises that the parties' intent is that the defaulting member would only lose the reclassified Tier 2 service upgrade (albeit, they would lose all of it, regardless of how much had already been paid for.) No contributions would be refunded and no reclassified service time would be retained, based upon a pro-ration of the amount paid.² For example, if a member with ten years of original Tier 1 service and 10 years of reclassified Tier 2 service, for which he has paid 90% of the upgraded cost, fails to pay for the final 1 year of cost, at retirement that member will be credited with only 10 years of Tier 1 service and 10 years of Tier 2 service, and receive neither the upgrade of those 9 years paid for, or a refund of the 9 years of additional payments already made. Whether or not the parties consider this fair treatment of affected members, at the very least the treatment should be spelled out with specificity in the proposed ordinance so the Boards know how to administer the benefits correctly at retirement. We recommend that the proposed ordinance clarify this point before the City Council votes to adopt it.

Conclusion

We believe that the proposed ordinance leaves several key provisions unnecessarily vague and ambiguous. We recommend that the Board forward these observations and recommendations to the City Council for its consideration in advance of the date the proposed ordinance is agendized for action, pursuant to Municipal Code sections 3.28.275 (Federated) and 3.36.485 (Police & Fire).

² Apparently this would also apply to "active death" members, *i.e.*, those who die during service and before they can complete their amortized payments, although OER states that "we will address this situation should it arise." We respectfully suggest that members' retirement benefit rights and obligations should not be premised on offers to "address" them in the future, however well meaning, but should rather be established with specificity in the governing plan documents.