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To: Investment Committee - San Jose Police and Fire Department Retirement Plan

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Subject: **Board Discretion Regarding The Discount Rate Used For Determining Actuarial Equivalence Of The City's Pre-Funding Option**

ISSUE BEFORE THE INVESTMENT COMMITTEE

Under Municipal Code section 3.36.1520, the City is required to make its contributions to the retirement plan on a monthly or bi-weekly basis. Frequently, however, the City has exercised its right under Municipal Code section 3.36.1590(C) to make its required contributions in a lump sum payment at the beginning of a fiscal year. Municipal Code section 3.36.1590(C) provides: "The amount of the advance periodic payment(s) contained in city's notice of intent shall be as determined by the board to be actuarially equivalent to the monthly or biweekly payment that would otherwise have been required." In the past, the Board's actuary has used the Board's then current assumed rate of investment return to determine "actuarial equivalence" for this purpose.

The Investment Committee has asked for our advice regarding whether the Board has discretion to direct its actuary to use a lower discount rate for the purpose of determining actuarial equivalence under section 3.36.1590(C), due to the additional risk posed to the fund by taking in all City contributions at once in a lump sum rather than on a monthly or bi-weekly basis over a full year. For the reasons stated below, we advise that the Board does have such discretion.

ANALYSIS

Municipal Code section 3.36.1590(C) provides:

"Commencing with fiscal year 2009-10, the city shall have an annual option to select the advance periodic basis on which city contributions to the medical benefits account and to the retirement fund for that fiscal year will be paid; provided that such payment schedule shall be no less frequent than quarterly. Except as may otherwise be agreed to by the board, the notice of intent to exercise the option, including the advance periodic basis selected and the payment date(s) (the 'notice of intent'), shall be provided by the city manager to the board on or before April 30th of the fiscal year prior to the fiscal year in which city may wish to exercise the option. The amount of the advance periodic

payment(s) contained in city's notice of intent shall be as determined by the board to be actuarially equivalent to the monthly or biweekly payment that would otherwise have been required."¹

Thus, the City has a right to elect the lump sum option, but the Board has the right to decide how to determine what is "actuarially equivalent." The Board has very broad discretion over actuarial matters. Article XVI, section 17(e) of the California Constitution provides: "The retirement board of a public pension or retirement system, consistent with the exclusive fiduciary responsibilities vested in it, shall have the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets of the public pension or retirement system." The Municipal Code is consistent with the California Constitution. *See generally* Muni Code §§ 3.36.300 *et seq.* Further, there are references to "actuarial equivalent" throughout the Municipal Code that require the use of a specific definition of that term. *See e.g.*, §§ 3.36.1466 and 3.36.730(E). This shows that the City Council knows how to use a specific definition when it wants to do so. For the City's lump sum payment option, however, the City Council used the phrase "as determined by the board," which further supports a conclusion that this is a matter of Board discretion.

Although the Board has adopted an assumed rate of investment return for funding purposes, which is the Board's best estimate of the likely long-term returns it will obtain on its investments, we believe the Board has authority to apply a different discount rate to determine "actuarial equivalence" over a short period of time, such as the year in which (a) contributions will be made either in lump sum at the beginning of the year or (b) periodically throughout the year on a monthly or biweekly basis. This is because it reasonable to take account of the fact that short term investment returns are more volatile than long term investment returns. We believe that the Board's decision on that subject would be reviewed by the courts under the deferential "abuse of discretion" standard. Thus, the key here is to make a decision based on the Board's best collective judgment after hearing all relevant facts and arguments and considering input from its actuary and outside investment consultants in an open and public process. If the Board goes through that type of thoughtful and transparent process, we are confident that the

¹ The phrase "no less frequent" is ambiguous and could be understood to *not* allow an annual prepayment, since one annual payment would appear to be "less frequent" than a quarterly payment schedule. From the materials that were before the City Council when it passed section 3.36.1590(C), however, we believe that the City Council used the phrase "no less frequent" to mean that the intervals between payments would be no shorter than quarterly. In other words, annual, semi-annual and quarterly payments would be allowed as an alternative to the normal monthly or bi-weekly payments, but bi-monthly payments would not be allowed. The amendment to the Municipal Code was described: "To provide additional flexibility for future business purposes, staff recommends that the amendment to the Municipal Code allow for quarterly and other period prepayments in addition to annual prepayments." Throughout the backup materials, there are several other statements that assume a "lump sum" annual payment will continue to be permitted after the City's lump sum annual payment in FY 2008-09, pursuant to Municipal Code section 3.36.1590(B). We also note that section 3.36.1590(C) includes references to "payment date(s)" and "periodic payment(s)." The use of the phrases "date(s)" and "payment(s)" – each with the parenthetical "(s)" – show it was understood that the prepayment might be comprised of a single lump sum payment. Otherwise, section 3.36.1590(C) would have used the words "dates" and "payments" without a parenthetical "(s)" in each word. Further, the City has, in fact, regularly made lump sum annual prepayments since FY 2009-10, demonstrating the City Council's understanding that the law it passed allowed for a lump sum annual payment.

Board has discretion to use a discount rate for determining the “actuarial equivalence” of City contributions that is lower than its assumed rate of investment return.

We also note the following:

As previously mentioned, the Board should be advised on these matters by its actuary and outside investment consultants, who can best identify and quantify for the Board the risk the Board takes by receiving a lump sum payment of investible cash at the beginning of a fiscal year, compared to the risk of essentially “dollar-cost averaging” its investible cash periodically throughout the year. The evaluation should, among other things, analyze the difference in risk present in different types of historical markets (e.g., mature vs. recovering).

We also note that the City’s contribution rate is already heavily dependent on numerous discretionary decisions of the Board. For example, the City’s rate would be higher or lower depending on (a) the numerous assumptions regarding mortality, wage increases, etc., used by the actuary, (b) the assumed rate of return (which is discretionary in the first instance), (c) discretionary smoothing of gains and losses, and (d) the amortization schedule, which is within the Board’s discretion to lengthen or shorten. Thus, whenever someone tries to challenge one aspect of the process, such as the determination of “actuarial equivalence” of a lump sum contribution, they are missing the fact that the Board could have arrived at the same place in other discretionary ways.

For the above reasons, we advise that the Board has broad authority and discretion to either (a) continue using its assumed rate of investment return for the purposes of determining actuarial equivalence under Municipal Code section 3.36.1590(C), or (b) use a lower discount rate for that purpose, if the Board determines, in consultation with its actuary and outside investment consultants, that doing so would more accurately reflect the actuarial equivalence of the contributions that would otherwise be collected on a monthly or bi-weekly basis throughout the fiscal year.