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San Diego City Employees' Retirement System

DROP Program Interest Rates

October 17, 2008

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Topics for Discussion

- Background
- Options
- Analysis
- Conclusions

Background

- DROP program interest assumptions
  - Crediting DROP account balances
  - Converting DROP account balances to annuities
- Since 1998, SDCERS has been using 8% for both crediting and converting
- Actuarial investment assumption was changed in September from 8% to 7.75%
- As a result, SDCERS' Board should examine available options

Options For Credits and Conversions

1. Change interest rates to 7.75%

2. Use a fixed but lower rate

3. Use a floating rate tied to a recognized market index (e.g., PBGC immediate annuity rates)

Analysis: Option 1
Change to 7.75%

- Will lower both the annual DROP account interest credit and the annuity conversion
- Consistent with prior SDCERS practice
- Cost neutral if actuarial Fund earnings are 7.75%
- Some systems apply the assumed rate of return
- The higher the interest credit and annuity conversion rate, the more members elect DROP
- The more members elect DROP the earlier the average age at retirement
- Earlier retirements result in increasing costs

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Analysis: Option 2
Use a fixed but lower rate

- Very supportable as 7.75 is much greater than
  - returns individuals can earn in a 5 year savings account
  - individual annuity purchase rates
- For these reasons use of a lower rate is increasingly becoming a favored approach for other DROP plans
- Costs and risk to the System are lowered
- Interest credits and annuity conversions are lower than if 7.75% rate is used
- Potential rates to consider
  - 5 year T-bills (today at 2.87%)
  - PBGC annuity rates (today at 5.25% – 6.18%)
  - LT investment grade corporate bond (today at 6.02%)
  - 30 year Treasury securities (today 4.22%)
  - Arbitrarily pick a rate less than 7.75%

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Analysis: Option 3
Use a floating rate

- Same points as with fixed rate apply
- Some increased *anti-selection* possible
- Advantage over fixed rate approach is that once set, the Board doesn't have to revisit
- One disadvantage is less Board flexibility

Primary Conclusions

- The higher the DROP interest rate is compared to what members could achieve on their own:
  - The more risks assumed by SDCERS to achieve that return; and
  - The greater the incentive is for a member to “retire” earlier and enter DROP
- The earlier a member retires, the higher the costs are to SDCERS

Experience Study Results

Table II – 1 Current Retirement Assumptions						
	All General Employees			**All Safety Employees**		
Age Range	**Actual**	**Expected**	**Ratio**	**Actual**	**Expected**	**Ratio**
50-54	--	--	--	266	62	4.29
55-59	476	107	4.45	64	55	1.16
60-64	175	114	1.54	8	14	0.57
65-69	43	38	1.13	1	1	1.00
70+	11	47	0.23	0	0	0.00
Totals	705	306	2.30	339	132	2.57

Table II – 2 Current Retirement Assumptions						
	All General Employees			**All Safety Employees**		
Age Range	**Normal Retirements**	**DROP Retirements**	**Total Retirements**	**Normal Retirements**	**DROP Retirements**	**Total Retirements**
50-54	--	--	--	40	226	266
55-59	142	334	476	8	56	64
60-64	61	114	175	2	6	8
65-69	23	20	43	1	0	1
70+	10	1	11	0	0	0
Totals	236	469	705	51	288	339