

June 5, 2006

Mr. Benito Romano
Willkie Farr & Gallagher
787 Seventh Avenue
New York, NY 10019-6099

Re: *Audit Committee of the City of San Diego*

Dear Mr. Romano:

Thank you for your inquiry and interview request on behalf of the Audit Committee of the City of San Diego.

I have put together the following materials per your request regarding same. I am happy to meet with you regarding these items, and others, as you deem helpful or appropriate.

The City of San Diego's fiscal year 2007 budget:

- **CONTINUES TO ILLEGALLY¹ UNDERFUND THE SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM (SDCERS) BY:**
 - **BACKLOADING BILLIONS OF DOLLARS OF DEBT INTO THE FUTURE VIOLATING THE PRINCIPLE OF "INTERGENERATIONAL EQUITY"² AND CREATING AN ACTUARIALLY UNSOUND PENSION PLAN;³**

¹ Several law firms hired by the City and SDCERS, including but not limited to Reish, Luftman, Reicher & Cohen; Seltzer Caplan; Pillsbury Winthrop; Hanson Bridgett; Jones, Day, Reavis & Pogue, and Morrison & Foerster have confirmed that making deficient payments to a California public retirement system such as SDCERS is in violation of the State and Federal Constitution, California State Law & Government Codes; the City Charter and the Municipal Code. These analyses cite numerous court cases including but not limited to: *Board of Administration v. Wilson*, 52, Cal.app.4th 1109 (1997); *Valdes v. Cory*, 139 Cal.App.3d 773 (1983); *Abbott v. City of San Diego*, 165 Cal.App.2d 511, 517 (1959); *Claypool v. Wilson*, 4 Cal.App.4th 646 (1992); *Masters v. San Bernardino County Employees Retirement Association*, 32 Cal.App.4th 30, 44; *Hittle v. Santa Barbara County Employees Retirement Association*, *supra*, 39 Cal.3d 374, 393; *City of Sacramento v. Public Employees Retirement System*, 229 Cal. App. 3d 1470; *Herrick v. The State of California*, (1983) 149 Cal. App. 3d 156; *In re Kuraishi*, 237 B.R. 172 (Bankr.C.D.Cal.1999); *Betts v. Board of Administration*, 21 Cal.3d. 859, 863-864 (1978); *Butt v. State of California*, 4 Ca1.4th 668, 697-703 (1992); *Matthews v. Ventura County Employees' Retirement Association*, Case No. CIV220607; *Singh v. Board of Retirement*, *supra*, 41 Cal.App.4th 1180; *Westly v. Board of Administration*, *supra*, 105 Cal.App.4th 1095; *In re Retirement Cases* (2003) 110 Cal.App.4th 426 457-460; *Thompson v. Call* (1985) 38 Cal.3d 633, 645; *People v. Gnass* (2002) 101 Cal.App.4th 1271, 1289, fn.6; *City of Taft* (1962) 58 Cal.2d 565, 569; *In re Russell* (1978) 61 Ops.Cal.Atty.Gen 243, 253.

² *See Investigation for the Board of Administration of the San Diego City Employees' Retirement System Legal Analysis and Conclusions* Prepared by Reish, Luftman, Reicher & Cohen, dated 1/20/06 by Navigant Consulting, page 45 of 127. "Intergenerational Equity" basically means that the benefits promised to one generation of employees is paid for by that generation of employees and taxpayers and the cost is not

- **ILLEGALLY “BORROWS” MONEY FROM SDCERS’ PENSION TRUST SOLELY FOR BUDGETARY PURPOSES;⁴**
- **DOES NOT “BALANCE” THE BUDGET BECAUSE THE CITY PENSION FUNDING PROCESS ROUTINELY INCORPORATES DEFICIENT CONTRIBUTIONS. THIS RESULTS IN THE CITY’S TRUE PENSION BILL NOT BEING PAID BUT RATHER HIDDEN, DEFERRED AND ACCRUED;**
- **CREATES LONG-TERM INDEBTEDNESS FOR THE CITY THAT EXCEEDS EVEN THE PROJECTED INCOME AND REVENUE GROWTH NECESSARY TO PAY IT IN A GIVEN TERM, ALL IN VIOLATION OF THE STATE CONSTITUTION AND CITY CHARTER.⁵**
- **MATERIALLY MISREPRESENTING THE TRUE FINANCIAL CONDITION OF THE CITY OF SAN DIEGO AND SAN DIEGO CITY EMPLOYEES’ RETIREMENT SYSTEM; AND**
- **WITHHOLDS MATERIAL INFORMATION REGARDING THE TRUE ANNUAL PENSION COST (APC); ANNUAL REQUIRED CONTRIBUTION (ARC) AND RESULTING NET PENSION OBLIGATION (NPO) FROM:**
 - THE “PLAN SPONSOR” CITY OF SAN DIEGO
 - PLAN PARTICIPANTS AND BENEFICIARIES,
 - CITIZENS OF SAN DIEGO,

pushed off onto future generations of employees and taxpayers. According to the California Court of Appeals in *Board of Administration v. Wilson*:

*“...the **most important general financial objective for any public retirement system is to practice Intergenerational equity**, which means calculating and receiving during each fiscal year contributions which during each fiscal year contributions which, expressed as percents of active member payroll, will remain approximately level from the present generation of citizens to future generations of citizens. This level contribution system ensures that the benefit promises made to employees for services rendered would be paid as promised in the future when employees retire.”* (Emphasis added.)

³ See *Investigation for the Board of Administration of the San Diego City Employees’ Retirement System Legal Analysis and Conclusions* Prepared by Reish, Luftman, Reicher & Cohen, dated 1/20/06 by Navigant Consulting. There are numerous examples of court decisions regarding the principles of actuarial soundness and intergenerational equity including but not limited to pages 39-40.

⁴ See *Report on Investigation The City of San Diego, California’s Disclosures of Obligation to Fund the San Diego City Employees’ Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code* dated September 16, 2004, by Paul S. Maco and Richard C. Sauer of Vinson & Elkins L.L.P., Washington D.C., pages 36-38.

⁵ By deferring the appropriate annual payment to the pension system the UAAL continues to grow and therefore debt is created with no identified revenue stream for repayment. See Article XVI, Section 17 of the State Constitution and Section 99 of the City Charter.

- THE PUBLIC,
- CAPITAL MARKETS,
- CITY OF SAN DIEGO BONDHOLDERS,
- BOND INSURERS, AND
- CREDIT RATING AGENCIES⁶

DISCUSSION

California law requires public retirement systems to be legitimately funded in a manner that ensures benefits granted to one generation of employees are paid for by *that* generation of employees and taxpayers. An intentionally deficient pension contribution results in an illegal loan from pension system assets.

Internal Revenue Service regulations require pension trust assets be used solely to pay pension benefits. Illegal loans result in a violation of Internal Revenue Code. If the "Annual Required Contribution" (per "GASB") is not made in a manner that ensures "Intergenerational Equity", it is in violation of California State Law.⁷ Finally, an intentionally deficient pension contribution results in a falsely balanced budget.

Three insidious intentional underfunding "deals" were created to conceal the fact that the pension system was "loaning" money to the City through hidden deficits. They are now known as Manager's Proposal I, II, and the *Gleason* settlement (also known as Manager's Proposal III). These serial backloading agreements were used in part to intentionally push off multi-billion dollar balloon payments into the future. They also provided for the reduction and/or deferral of payments for pension enhancements received by union executives, senior city management and political office holders.

Notwithstanding any deficiencies in the reports from Navigant Consulting and Vinson & Elkins, these reports confirm the City's long history of intentionally underfunding its pension since at least 1990. Year after year deficient contributions have been made by using "actuarial vagaries",⁸ "illegal"⁹ underfunding agreements such as Manager's Proposal I, Manager's Proposal II, and the *Gleason* settlement; and, by the siphoning off of system assets, among other things. This illegal deferral of payments is "in-arrears

⁶ Notwithstanding city officials comments to the contrary, it is highly doubtful that major credit rating agencies would encourage or recommend in good faith that a public employees' retirement trust be intentionally underfunded and backloaded by the plan sponsor. – See San Diego Daily Transcript Article, March 17, 2006, by Doug Sherwin, "Pension deficit less than feared, but 'not a day to declare victory', Chief Financial Officer Jay Goldstone, *"Talking to rating agencies, they don't believe you need to 100 percent fund the system," he said. "And they encourage you not to."* No financial periodicals or underwriters subscribe to this illegal (in California) position.

⁷ See *Board of Administration v. Wilson* (1997).

⁸ See Vinson & Elkins report, page 5.

⁹ See Navigant Report Legal Analysis.

financing” that backloads contributions to future years in violation of California state law.¹⁰

Past corrupt processes are still in use today to allow the City to pretend to balance its fiscal year 2007 budget by borrowing money from its *secret bank*: the pension plan. These dangerous past/current practices include, but are not limited to:

- Intentionally using inappropriate actuarial assumptions, methods and calculations just to lower the budgeted amount for the pension contribution;
- Utilizing pension plan earnings to fulfill other financial obligations;
- The City Council and SDCERS Board agreeing to a less than full actuarial contribution by the City; and
- The budgeted pension contribution amount not being sufficient to pay either the principal or interest on the deficit.

Notwithstanding the fact that the **SDCERS funded ratio is now 22% lower than it was when the City Council approved Manager’s Proposal II and there is now only about 19 cents for every dollar necessary to pay for the retirement benefits of current City employees (down from about 87 cents several years ago)**,¹¹ SDCERS and City officials acknowledge this year’s recommended and approved budgeted FY ’07 pension contribution is deficient and:

- Is **not** sufficient to cover the “normal cost” and interest on past service cost computed at actuarial funding rates
- Will cause the Unfunded Accrued Actuarial Liability (UAAL) to continue to grow.¹²

This year's deficient pension contribution is a direct result of the infamous Manager’s Proposal II and the artificial and discredited assumptions contained in what is known as the *Gleason* settlement, a private lawsuit settlement agreed to by the very parties that participated in the creation and/or approval of Manager’s Proposals I and II.

The *Gleason* settlement, just like Manager’s Proposals I and II, intentionally underfunds using small contribution numbers up front and backloading huge balloon payments for the future. The former fiduciary counsel to the Retirement Board wrote this about the *Gleason* deal: “...the *Gleason Settlement is illegal because it intentionally permits*

¹⁰ See *Board of Administration v. Wilson*, 1997.

¹¹ See page 33 of the *SDCERS City of San Diego June 30, 2005 Actuarial Valuation* prepared by Cheiron.

¹² See San Diego Daily Transcript Article, March 17, 2006, by Doug Sherwin, “Pension deficit less than feared, but ‘not a day to declare victory’. In that article the Mayor is quoted as saying: “Do I think (\$162 million is) enough to meet our obligations? No, I don’t. At this rate, the liability will continue to grow. It’s a floor, and I think it gives us a good starting point for moving forward.”

*underfunding...*¹³ Yet, the 2007 contribution figure of \$162 million is exactly as set forth in Gleason.¹⁴

Best practices in pension actuarial and accounting standards, in addition to the San Diego Municipal Code, direct “experience valuations” be done to “true up” retirement assumptions with reality. One was done in 2005. But *this* fiscal year 2007 budgeted contribution number isn’t based on *that* information. Instead it’s based on outdated numbers in the Gleason settlement intentionally used to underfund. Even the Council’s own outside attorneys Vinson & Elkins warned of the retirement system’s use of assumptions that “do not comport with reality.”¹⁵ The City’s own actuary Towers Perrin, the SDCERS’ actuary Rick Roeder and the SDCERS’ outside consultant Mercer recommended changes regarding assumptions and cost methods. But, the recommendations have not been implemented.

The Pension Reform Commission (PRC) Minority Report noted references to pension contributions calculated pursuant to the Gleason settlement as being “full funding” were both “creative” and “disingenuous”.¹⁶ This was because such contributions (i.e. this year’s \$162 million) are *only* determined by explicitly changing the following critical assumption: the amortization period for the unfunded liability was extended from the existing 18 years to 30 years. This actually takes the amortization period out to 68 years, because it was extended before. This allows the unfunded liability to continue to grow (all other variables held constant). The PRC’s Final Report states that any amortization schedule longer than 15 years leads to “negative amortization” which pushes the debt onto future employees and taxpayers and is considered a “highly inappropriate fiscal policy.”¹⁷

I. THE FISCAL YEAR 2007 BUDGETED \$162 MILLION CONTRIBUTION IS BASED ON THE GLEASON SETTLEMENT WHICH IS ILLEGAL AND VOID

¹³ See Memorandum of Points and Authorities In support of Application for Determination of Good Faith Settlement by Reed Smith LLP on behalf of Bob Blum.

¹⁴ Even the Pension Reform Committee said the minimum contribution amount owed was north of \$200 million – *just to keep the deficit from growing*. And - that was several years ago. Now the deficit is much larger - so the amount owed is more – not less! And, that amount admittedly does not even begin to pay the deficit down.

¹⁵ See Report on Investigation The City of San Diego, California’s Disclosures of Obligation to Fund the San Diego City Employees’ Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code dated September 16, 2004, by Paul S. Maco and Richard C. Sauer of Vinson & Elkins L.L.P., Washington D.C.

¹⁶ See Pension Reform Commission Minority Report by Richard Vortmann dated September 2005 pages 11 & 12.

¹⁷ See Pension Reform Commission Minority Report by Richard Vortmann dated September 2005 page 12.

Even SDCERS former fiduciary counsel Hanson Bridgett (subsequently sued for malpractice and quickly settling for policy limits) figured out Gleason was illegal because it continued to underfund.¹⁸

Both the City and SDCERS knew the Gleason settlement violates California's conflict of interest laws, Government Code Section 1090. That's why the mysterious "Abrogation of 1090 Resolution" was created and read into the record just moments before that Board voted on the Gleason Settlement. (When asked who authored the resolution, the SDCERS Board President said it was a secret.) The Board did not want to follow appropriate procedures because it would not have enough votes for the settlement to pass.

Because the "settlement" was illegal and might be challenged at a future date resulting in the City having to make the normally required larger contributions in FY 2005 to 2008, the Gleason settlement was further protected by changing the City Charter to allow for funding calculations approved in *lawsuit settlements* (Proposition G). San Diego may be the only place in America that has a City Charter allowing illegal pension funding under private law suit "settlements".

The former Chair of the Pension Reform Commission, Ms. April Boling, (who co-authored the ballot argument in support of Proposition G¹⁹ in 2004), now confirms the Gleason settlement (and its corresponding FY 2007 \$162 million contribution) actually continues the practice of intentionally underfunding. The following is from Ms. Boling's May 23, 2006 Union Tribune Opinion piece:

"If the city pays that \$162 million bill without augmentation, the pattern of underfunding will have continued. At a bare minimum, the payment should be in the \$200 million to \$225 million range, just to stop the deficit from growing... Why is the bill understated? The answer is that it has been calculated in strict accordance with the terms of the Gleason settlement. That settlement included a provision that froze many of the key actuarial assumptions. The Gleason settlement was a three-part agreement between retired city employee Jim Gleason, the city of San Diego and the San Diego City Employees' Retirement System, or SDCERS. Of the three parties, it was the city that demanded the freeze. Why? Because it was afraid that the retirement board might, as the result of public criticism, change some of the assumptions or the debt amortization period, thereby increasing the required payment. Put another way, Gleason wouldn't have been able to get the city to agree to increased payments for 2005 through 2008 unless he agreed to the frozen assumptions. He also was essentially forced to agree to a plan whereby the city is not even paying the full interest on the unfunded liability each year. And to the extent it is not, the difference gets

¹⁸ See Bob Blum Memorandum of Points and Authorities: *...the Gleason Settlement is illegal because it intentionally permits underfunding...*

¹⁹ The ballot argument in favor of Proposition G was signed by former Mayor Dick Murphy, Council Member Scott Peters, former executive director of the Taxpayers Association Lisa Briggs and PRC Chair April Boling. I wrote the ballot argument against Proposition G. Prop G included some other language that gave the impression of improving certain actuarial methods but only *after* July 1, 2008

*added to the outstanding debt. For the coming year, that shortfall alone appears to be about \$35 million. One would hope that, by now, our city leadership understands that **use of those assumptions is not in the best interest of the retirement plan.** And, what's bad for the retirement plan is also, over the long term, bad for the city."*

While the Court may have approved the settlement, the Court was not advised that the settlement continued the intentional underfunding, nor was the court asked to rule if intentional underfunding was legal. So, the city and SDCERS did indirectly what they could never do directly.

It is notable that when the Charter language in Section 143 regarding retirement contributions was changed by Prop G to include funding pursuant to lawsuit settlements the following sentence was rumored to have been included by insiders who crafted the language *only* because they knew that the *Gleason* settlement was illegal therefore in the event the Board or City was sued there would be a safeguard clause that would allow a remedy for legal contributions under the Charter:

“Notwithstanding the above, the Board shall retain plenary authority and fiduciary responsibility for investment of moneys and administration of the system as provided for in article XVI, section 17 of the California Constitution.”

II. THE \$162 MILLION CONTRIBUTION RESULTS IN AN ILLEGAL LOAN AND FALSELY BALANCES THE BUDGET BY DEFERRING DEBT INTO THE FUTURE FOR WHICH THERE IS NO IDENTIFIED REVENUE STREAM FOR REPAYMENT

By approving an intentionally deficient pension contribution the City and SDCERS have agreed that the City can borrow money from the retirement system. Loans of this sort are known to be illegal, which is why SDCERS board members were cautioned not to use the word “loan” but to call the contribution relief a “transfer among reserves”.²⁰

A loan of this nature is:

- A debt that the City was not reporting; and
- Debt that violates the debt limitation provisions of the State Constitution and the City Charter.²¹

The City’s budget is not “balanced” by moving debt “off balance sheet” and illegally borrowing money from the pension trust via intentionally deficient pension contributions. This may have been the way it has been done in San Diego, but as the law firms hired by

²⁰ See SDCERS Board Minutes, SDCERS has known for a long time that this practice results in illegal loans - see SDCERS Board Minutes, 4/21/95, page 21, “Mr. Grissom reminded the Board that their comments are being recorded and cautioned them against calling this a loan.”

²¹ See State of California Constitution Article XVI, Section 17 and San Diego City Charter Section 99.

the City and SDCERS have concluded: it is not legal. To publicly claim that the fiscal year 2007 budget is “balanced” when it includes an intentionally deficient pension contribution continues to misrepresent the financial condition of the City.

California Constitution Violation

Article XVI, section 17 of the California Constitution states debt may not be imposed on citizens without a vote of the people:

“No...city...shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the voters of the public entity voting at an election to be held for that purpose.”

The \$162 million contribution creates long-term indebtedness for the City in excess of income and revenue necessary to sustain the indebtedness on a yearly basis.

City Charter Section 99 Violation

The San Diego City Charter Section 99 mirrors the above referenced language of the California Constitution:

“The City shall not incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year unless the qualified electors of the City, voting at an election to be held for that purpose, have indicated their assent as then required by the Constitution of the State of California, nor unless before or at the time of incurring such indebtedness provision shall be made for the collection of an annual tax sufficient to pay the interest on such indebtedness as it falls due, and also provision to constitute a sinking fund for the payment of the principal thereof, on or before maturity, which shall not exceed forty years from the time of contracting the same.”

According to the State Constitution and the City Charter, the only way that such a financial liability can be legally created is through a citywide election.

III. THE \$162 MILLION CONTRIBUTION VIOLATES THE PRINCIPLE OF “INTERGENERATIONAL EQUITY”

"Intergenerational Equity" basically means that the benefits promised to one generation of employees is paid for by that generation of employees and taxpayers and the cost is NOT pushed off onto future generations of employees and taxpayers.

According to the California Court of Appeals in Board of Administration v. Wilson:

“...the most important general financial objective for any public retirement system is to practice Intergenerational equity, which means calculating and receiving during each fiscal year contributions which during each fiscal year contributions which, expressed as percents of active member payroll, will remain approximately level from the present generation of citizens to future generations of citizens. This level contribution system ensures that the benefit promises made to employees for services rendered would be paid as promised in the future when employees retire.”²² (Emphasis added.)

In essence a deficient contribution will push a portion of the current year’s payment off onto future generations of taxpayers and employees. This is known as “deferring” the payment or “in arrears” financing which the California State Courts have found to be illegal.²³ The Courts have stated clearly that delayed contributions are illegal because:

- *“When monies are contributed later than expected, reduced earnings result, thus creating a shortfall...this impairs the benefit security and causes a portion of the total current employment cost of plan members to be shifted to the future”*
- *“Any delay in payment of the employer contribution will result in a combination of a permanent shortfall in plan assets together with an increased annual contribution requirement”* and
- *“Delaying the payments for currently emerging liabilities places the responsibility of those liabilities onto a future generation of taxpayers.”²⁴ (Emphasis added.)*

IV. THE \$162 MILLION CONTRIBUTION IS ILLEGAL BECAUSE IT CREATES AN ACTUARIALLY UNSOUND PENSION PLAN

The definition of actuarial soundness is:

“The financial objective of the pension plan shall be to establish and receive contributions which will remain approximately level from year to year and will not have to be increased for future generations of citizens. This objective is achieved when contributions received each year by the pension fund are sufficient both, (1) to fully cover the costs of benefit commitments being made to employees for their service being rendered in such year and, (2) to make a level payment which, if paid annually over a reasonable period of future years, will fully cover

²² See Investigation for the Board of Administration of the San Diego City Employees’ Retirement System Legal Analysis and Conclusions Prepared by Reish, Luftman, Reicher & Cohen, dated 1/20/06 by Navigant Consulting, page 45 of 127.

²³ See various legal analyses cited in footnote 1.

²⁴ See pages 45-46 of the Legal Analysis prepared by Reish Luftman Reicher & Cohen contained in the January 20, 2006 Navigant Report.

the unfunded costs of benefit commitments for service previously rendered.”²⁵
(*Emphasis added.*)

And, the “*elements of actuarial soundness*” are as follows:

- “*Contributions should be level from year to year and not transfer the liability for funding benefits of current Members on future generations*”
- “*Contributions received each year should be sufficient to fully cover the costs of benefit commitments being made to Members for the current year’s service.*”
- “*Contributions received each year should also be sufficient to make a level payment that will fully amortize unfunded costs for benefits related to previously rendered services.*”²⁶

According to the Hanson Bridgett firm, “*The courts have made it clear that an actuarially sound, annual contribution is the key element in providing for the integrity and soundness of a retirement fund.*”²⁷

Again, the California courts are clear that the practice of delayed contributions is illegal because it is actuarially unsound:

- “*in arrears financing*” is “*actuarially unsound*”
- “*when contributions are delayed...the plan falls out of actuarial balance and actuarial soundness is endangered*”
- “*... underpinning both the normal cost calculation and the amortization of the unfunded accrued actuarial liability [UAAL] is an explicit assumption concerning the timing of contributions...The importance of timing stems from the fact that a large portion of a member’s benefit is funded by the investment earnings which are generated by plan contributions...* ”²⁸

V. THE \$162 MILLION CONTRIBUTION IS NOT A “MINIMUM” AMOUNT BECAUSE THERE IS NO SUCH THING AS A “MINIMUM” PENSION CONTRIBUTION²⁹

²⁵ See page 98 of the Legal Analysis of the Navigant Report.

²⁶ See Page 85 of the Legal Analysis of the Navigant Report.

²⁷ See Page 13 of the 6/12/02 Letter From Hanson Bridgett Robert Blum who cites *Wilson*, 52 Cal.App.4th at 1134-1135, citing *California Teachers Assn. v. Cory*, “*the court noted that the disruption of annual installments of reserves for normal cost is an invasion of the trust’s reserve that impairs the employee’s right to sound funding.*”

²⁸ See pages 45-46 of the Legal Analysis prepared by Reish Luftman Reicher & Cohen contained in the January 20, 2006 Navigant Report.

²⁹ See San Diego Daily Transcript Article, March 17, 2006, by Doug Sherwin, “Pension deficit less than feared, but ‘not a day to declare victory’.

While the current Mayor and Council may have inherited the problem there is no justification for continuing what has been done in the past and approving illegal and deficient contributions to SDCERS. This opportunity should be used to actually fix the problem by calculating the “Annual Required Contribution” and funding it in a manner that ensures Intergenerational Equity.³⁰

VI. FULL PAYMENT OF THE ARC IN A MANNER THAT ENSURES INTERGENERATIONAL EQUITY COMPLIES WITH STATE LAW

Disciplined payments of the GASB defined ARC every year is the best way to create an actuarially sound plan that complies with legal requirements to ensure benefits granted to one generation of employees are paid for by that generation of employees and taxpayers. For the benefits *legally* granted over the past ten years to be paid for by the appropriate generation of employees and taxpayers the unfunded liability must now be amortized on a *15-year fixed* amortization schedule. Even the new SDCERS Actuary confirmed as much at the March 17, 2006 SDCERS Full Board Meeting. It should be noted that under the SDCERS methodology the use of an “*open*” or “*rolling*” amortization schedule to pay off the \$1.4 Billion (at least) unfunded liability would require more than 300 years to retire the deficit!

VII. PAYING A “VOID” OBLIGATION IS PAYING A “GRATUITY” IN VIOLATION OF LAW

To the extent there is a deficit created from a contractual agreement for which there was no identifiable funding, that element of the UAAL must be recognized as void and not paid. Paying a “void” obligation is a “gratuity” which would be yet another illegal action. However, after recognizing and eliminating the “void” portion from the UAAL the City can grant replacement benefits in whole or in part provided they are structured in a manner that is consistent with the required legal funding procedures. In doing it that way the obligations will be not subject to later set aside and the economic support for the payment of those obligations will be in place.

VIII. SDCERS BOARD AND ACTUARY MAY HAVE BREACHED FIDUCIARY DUTY

The City, SDCERS Board and its actuaries have worked together to lower the effect of the pension funding problems on the City’s financial statements. The SDCERS Board

³⁰ See GASB Summary of Statement No. 27 & 25 at www.gasb.org. The Annual Pension Cost equals the Annual Required Contribution (ARC) + Interest on the Net Pension Obligation (NPO) + a technical adjustment to the ARC. The ARC includes the “normal cost” and the payment to amortize the deficit (UAAL). The ARC must be calculated according to GASB parameters, including the appropriate amortization schedule to ensure “Interperiod equity”. And, the NPO must be calculated *as of* 1986 even though it was not necessary to report it until 1996. The City has not accurately reported its NPO or its ARC.

and its actuaries did not require the City to contribute the ARC in a manner that ensures funding integrity and Intergenerational Equity.

A May 13, 2004 letter from SDCERS outside counsel Seltzer Caplan to former Retirement System Administrator Lawrence Grissom noted: “...*the Board did not actively investigate the City’s ability to make payments as promised...the Board was warned...that it is held to the standard of a professional banker, and must investigate both the credit, and ability to pay, of someone seeking relief from a financial obligation by deferring all or part of that obligation beyond the existing due date...The Court could well be influenced...that it [the Board] did not discharge this duty, thus jeopardizing the long term stability of the Retirement System by granting relief to an insufficiently creditworthy entity...breach of fiduciary duty...will ultimately come down to...the undisputed fact of underfunding in light of case law holding that ‘when contributions are delayed beyond the date assumed[by the actuary], the plan falls out of balance and actuarial soundness is endangered.’* (Board of Administration v. Wilson, 52 Cal.App.4th at 1140).”(Emphasis added)

A March 2005 letter from Seltzer Caplan stated SDCERS breached fiduciary duty by approving Manager’s Proposal 2 “because it resulted in a lower contribution obligation for the City.”³¹

These same fiduciary duty issues may be applied *now* to the current SDCERS Board and actuary for their actions to provide the City with continued contribution relief by only requiring the knowingly deficient amount of \$162 million for the FY 2007 contribution, a calculation based on fictional actuarial assumptions and methodologies.

IX. \$162 MILLION FY 2007 CONTRIBUTION NOT FULLY GASB COMPLIANT

In a May 16, 2006 letter to SDCERS regarding the June 30, 2005 actuarial valuation, Cheiron actuary Gene Kalwarski writes: “...*the contribution rates and dollar amounts shown...are in **full** compliance with Governmental Accounting Standards Board (GASB) Statement No. 15 as far as determining the annual required contributions (ARC).*” A May 23, 2006 Memorandum from SDCERS Retirement Administrator David B. Wescoe to Councilmember Donna Frye also states “*The ARC has been computed in accordance with the parameters set by GASB Statement No. 25...*”

Neither of these statements is correct. The contribution rates and dollar amounts do not **fully** comply with GASB Statement No. 25. The SDCERS June 30, 2005 actuarial valuation confirms that “certain liabilities ...are **not** reflected in the determination of costs and liabilities disclosed elsewhere in this report” (emphasis added) and that certain assets are **excluded**. These practices openly violate the GASB requirements.

The new actuary has recommended continuing to use the “*Gleason*” based actuarial assumptions contained in the June 30, 2004 Actuarial Valuation even though:

³¹ See page 3 of the 3/5/02 Seltzer Caplan letter to SDCERS.

- Assumptions should be based on the most current data available from the May 2005 experience investigation³² because experience investigations are supposed to be used to “*evaluate assumptions.*”³³
- The former SDCERS actuary *and* outside consultant Mercer recommended certain assumptions be changed, including but not limited to, lowering the assumed rate of return, including all liabilities such as the Retiree Corbett liability and administrative expenses, and improving the mortality assumptions.³⁴
- The new actuary admitted it would be more appropriate to use a 15 year fixed amortization schedule to comply with Intergenerational Equity.³⁵
- It is now widely known underfunding of SDCERS was accomplished through “*adjustments to the actuarial methods and assumptions*” and “*vagaries of 'actuarial science'.*”³⁶
- The Navigant Report raised serious questions about the former actuary’s annual valuations including the June 30, 2004 Valuation such as:
 - “*The annual actuarial valuations prepared for SDCERS contained misleading statements about the funding objectives and practices.*”³⁷
 - “*The valuation reports did not make it clear that the City was underfunding the System.*”³⁸
 - “*...general statements are inconsistent with the actual funding that was occurring.*”³⁹
 - “*In most of the valuations it was not clear that the City was not paying the rates determined by the actuarial calculations.*”⁴⁰

³² See page 102 of the Navigant report: “*GRS completed the experience investigation, covering the period July 1, 2001 to June 30, 2004, in May 2005. As a result, it has not been incorporated into an annual actuarial valuation.*”

³³ See page 17 of *Audit of Actuarial Work, San Diego City Employees' Retirement System*, by Mercer dated 5/11/04.

³⁴ See page 102 of the Navigant Report: “*GRS stated a 'slight preference' to reduce the 8% assumed rate of investment earnings.*” See page 4 of Mercer’s 5/11/04 report: “*GRS recommended a reduction in the investment return assumption of 25 basis points...We concur with that recommendation.*”

³⁵ At the 3/17/06 SDCERS Board meeting the new actuary statement it would be more appropriate for the system to use a 15-year amortization schedule to pay for the benefits granted over the past 10 years rather than a 30-year amortization schedule contained in the June 30, 2004 Valuation.

³⁶ See page 2 of 114 in the Navigant Report and page 5 of the Vinson & Elkins report.

³⁷ See page 6 of 115 and page 66 of 127 in the Navigant Report dated 1/20/06.

³⁸ See page 99 of the Navigant Report.

³⁹ See page 100 of the Navigant Report.

⁴⁰ See page 100 of the Navigant Report.

X. COUNCIL MAY NOT DELEGATE FISCAL MANAGEMENT

According to the City Charter, Article III, Section 11.1, the City Council may not delegate responsibility for fiscal management:

“The same prohibition against delegation of the legislative power which is imposed on the State Legislature by Article XI, Section 11a of the Constitution of the State of California shall apply to the City Council of the City of San Diego, so that its members may not delegate legislative power or responsibility which they were elected to exercise in the adoption of any ordinance or resolution which raises or spends monies, including but not limited to the City’s annual budget ordinance or any part thereof, and the annual ordinance setting compensation for City employees, or any ordinance or resolution setting public policy.”

The Council may not artificially and “blindly” rely on recommended contribution amounts provided by SDCERS. As is now well know, SDCERS has a host of problems including illegally loaning money to the City for budget balancing purposes. But, here, the Council clearly now knows:

- The pension system is unsound,
- The City has been underfunding for at least a decade,
- Full "Annual Required Contributions" have not been made,
- This year's \$162 million contribution amount is deficient, and
- This is another attempt to “balance the budget” with an illegal loan from the City employees' pension trust.

Even SDCERS’ new fiduciary counsel specifically warned of "rubber stamping" items such as the pension contribution:

“The era of ‘rubber stamp’ boards composed of members who accept and approve staff and consultant’s proposals and recommendations without carefully evaluating and considering them is over...all board members...have a serious and awesome fiduciary duty in administering large amounts of public money...to ensure that such funds remain actuarial solvent to meet all current and future promised pension benefits. Failure to perform these critical fiduciary responsibilities...with such actions causing serious jeopardy to the actuarial soundness of the funds...will, upon proper request, result in appropriate judicial action, in order to protect both public employees and taxpayers.”⁴¹

XI. PUBLIC DISCUSSION REQUIRES FULL DISCLOSURE

⁴¹ Page 5 of the Legal Analysis in the Navigation Report, Tentative Statement of Decision, Mathews v. Ventura County Employees’ Retirement Association, Ventura County Superior Court, CIV220607, December 13, 2005.

In order to ensure compliance with federal securities law the Council's public discussion of the proposed budgeted amount for the FY 2007 pension contribution should have included:

- Accurate numbers for the Annual Pension Cost, the Annual Required Contribution and the Net Pension Obligation.
- Projections from 2007 to 2021 (not projecting just to 2011 or 2014 in order to hide the true impact) for the APC, ARC and NPO, and
- Discussion of the economic impact of the APC, ARC and NPO on the City's current and future budgets.
- Discussion of the legal analyses received by the City and SDCERS that cite numerous court findings that underfunding is illegal.
- Discussion of the legal ramifications to the City, its elected officials, and the SDCERS Board of making a false claim that the budget is "balanced" when in reality it is not "balanced" and illegal debt is being created with no identified source of revenue to repay it.
- Discussion of potential violation of Constitution and Charter by incurring indebtedness that exceeds the income and revenue provided for in 2007 without a vote of the citizens.⁴²

To not include all relevant information in public discussion of this important item may misrepresent the City's financial condition to interested parties such as existing bondholders that may watch the discussion on television or read about it in newspapers.

XII. THE BUDGET IS NOT *STRUCTURALLY* BALANCED

Beyond not balancing the budget at all if the pension contribution is deficient, the suggested additional *one-time* revenue "solutions" of Tobacco revenue securitization or one-time land sales are, as the credit rating agencies have noted, "*more a solution in form than substance.*"⁴³

Capital Markets need to see a structurally balanced budget, as was noted in the most recent Moody's Report dated February 16, 2006:

"Solutions to the financial challenges faced by the city are not yet clear, much less implementation of specific steps to achieve structural balance."

The Moody's report also makes it clear that one time tobacco revenue solution was not a way to accomplish a structurally balanced budget:

⁴² See State of California Constitution Article XVI, Section 18 and San Diego City Charter Section 99.

⁴³ See Moody's Report Re: City of San Diego Report Dated February 16, 2006.

"Securitizing the city's tobacco settlement revenues has been suggested as a potential source of funding for the pension system, but this is more a solution in form than substance as it does not address the city's structural budgetary imbalance."

XIII. SUBSTANTIVE LEGAL ANALYSES CONFIRM UNDERFUNDING VIOLATES THE LAW; SDCERS ALREADY FINANCIAL UNSOUND

The deficient contribution was approved despite the knowledge that:

- SDCERS is already seriously underfunded and financially unsound;⁴⁴
- There is an unusually long history of intentional underfunding by the City of San Diego, and
- An extensive body of legal work that has confirmed intentional underfunding violates the law.⁴⁵

Consider the following legal conclusions of SDCERS special fiduciary counsel Reish, Luftman, Reicher & Cohen in the January of 2006 Navigant Report (They were not asked to opine on the *Gleason* settlement but the comments would equally apply to it.):

- *"The funding arrangements agreed to by the Board in 1996 and 2002, in MP 1 and MP 2, respectively, failed to assure the "competency" of the Retirement System assets as required by the state Constitution."*
- *"The City has sought alternatives to reduce its contributions to SDCERS since at least as early as 1991."*⁴⁶
- *"The city contributed less than the Actuarial Required Contribution resulting in the underfunding of SDCERS since at least as early as 1996. The City has not made up for contribution shortfalls from previous years."*⁴⁷
- *"These funding arrangements violated the contract clauses of the state and federal Constitutions by permitting SDCERS to be significantly underfunded."*
- *"These funding arrangements violated the state Constitution's restrictions on political interference in the administration and funding of SDCERS."*⁴⁸

⁴⁴ Even back in June 2002, the former fiduciary counsel, Hanson Bridgett, acknowledged that "SDCERS current funding integrity and security has been adversely impacted by application of the Managers Proposal." See page 8 of the 6/12/02 Letter From Robert Blum to SDCERS.

⁴⁵ Intentional underfunding of a public retirement system violates the law for numerous reasons that have been discussed at length in legal analyses performed for the City and SDCERS by numerous law firms including but not limited to: Vinson & Elkins; Seltzer Caplan; Pillsbury Winthrop; Reish, Luftman, Reicher & Cohen; Hanson Bridgett; Jones, Day, Reavis & Pogue; and Morrison & Foerster.⁴⁵

⁴⁶ See page 5 of the Navigant Report.

⁴⁷ See page 5 of the Navigant Report.

⁴⁸ See page 9 of 127 of the Legal Analysis in the Navigant Report.

SDCERS former fiduciary counsel Hanson Bridgett noted, "...the California Courts have stated several times that a key element of the operation of a retirement system such as SDCERS is to ensure the financial integrity and security of the system."⁴⁹ Hanson Bridgett noted in the Wilson case "the court thoroughly reviewed the obligation of an employer to fund a retirement system on an actuarially sound basis"⁵⁰ citing the court as stating:

- *"There is a vested right to 'integrity and security of the course of funding for the payment of benefits.' "52 Cal.App.4th at 1136, quoting from Valdes, 139 Cal.App.3d at 785."*
- *"The willingness and ability of the sponsor of a defined benefit pension plan to maintain this 'orderly schedule' [of contributions well in advance of benefit requirements] is the major factor in the assurance of benefit security for retirees.... "51 Cal.App.4th 1139 quoted from the declaration of the PERS actuary."*

SDCERS outside Counsel Pillsbury Winthrop concurred:

- *"...in arrears" funding legislation constituted an unconstitutional impairment of contractual obligations "⁵¹*
- *"The concept of actuarial soundness is incorporated into fifteen statutes within the Government Code. "⁵²*
- *"The court [in Wilson] pointed out that: '...Actuarial soundness of the system is necessarily implied in the total contractual commitment, because a contrary conclusion would lead to express impairment of employees' pension rights. "⁵³*
- *"Although no court has specifically determined that the members of SDCERS have a contractual right to an actuarially sound pension system...we will assume that such a right does exist, as the court in Wilson held as to CALPERS. "⁵⁴*
- *"We are certainly aware that prior agreements with the City have resulted in an extended period of underfunding of SDCERS...since underfunding of SDCERS has already continued for so many years, it is now time to make additional attempts to substantially accelerate SDCERS funding. "⁵⁵*

⁴⁹ See page 10 of the 6/12/02 Letter From Hanson Bridgett to SDCERS.

⁵⁰ See page 13 of the 6/12/02 letter from Hanson Bridgett to SDCERS.

⁵¹ See Page 20 of the 5/14/04 letter From Pillsbury Winthrop to SDCERS.

⁵² See Page 21 of the 5/14/04 letter from Pillsbury Winthrop to SDCERS.

⁵³ See page 20 of the 5/14/04 letter from Pillsbury Winthrop to SDCERS.

⁵⁴ See page 24 of the 5/14/04 letter from Pillsbury Winthrop to SDCERS.

⁵⁵ See page 24 of the 5/14/04 letter from Pillsbury Winthrop to SDCERS.

SDCERS litigation counsel Seltzer Caplan stated SDCERS breached fiduciary duty by approving MP-2, “because it resulted in a lower contribution obligation for the City.”⁵⁶

Even with SDCERS’ and the City’s past practice of “shopping” for legal opinions to justify desired actions,⁵⁷ and the use of a manipulative technique that Vinson & Elkins called “play-off” (in which City staff plays one law firm off of another one in an attempt to pressure each for the desired opinion),⁵⁸ the City and SDCERS have been able to find a law firm to opine that the contrived intentional underfunding of SDCERS is legal.

In general, intentional underfunding of a public retirement system violates the law for three reasons:

1. It pushes the cost of benefits granted to one generation of employees onto future generations of employees and taxpayers.
2. It creates an actuarially unsound pension plan.⁵⁹
3. It creates long-term indebtedness that exceeds the income and revenue necessary to sustain the indebtedness on a yearly basis.

XIV. THE 80-85% PROPOSED “TARGET” FUNDED RATIO IS NOT AN APPROPRIATE BASIS FOR A FUNDING POLICY

The prior City Manager proposed a funding strategy to get to 80-85% funded ratio in a matter of years. As noted by several independent experts and SDCERS outside fiduciary counsel, using a funding ratio is “an inappropriate basis for setting a funding

⁵⁶ See page 3 of the 3/5/02 Seltzer Caplan letter to SDCERS.

⁵⁷ See page 6 of Navigant Report: “SDCERS engaged different fiduciary counsel on a least four separate occasions to evaluation each of the City’s contribution reduction requests.” Also see page 33: “...at the May 1995 Board meeting, Morrison & Foerster LLP advised the Board that the transfer of funds was not appropriate...during the meeting some Board members recommended obtaining a second legal opinion while other Board members said, ‘The fact that the Board does not like this answer is not justification to seek a second opinion.’” Nevertheless, the Board did seek a second opinion because Morrison & Foerster concluded (in a letter dated 8/22/95 to former SDCERS Administrator Lawrence Grissom) that the practice of using surplus earnings to pay for retiree health care benefits “transgresses the constitutional and statutory trust obligations that govern the use of Surplus Earnings and that prohibit the diminution of retirement assets to pay non-retirement-trust liabilities.” Morrison & Foerster was fired in order for the Board to find a law firm that would give an opinion it “could better understand.” See SDCERS Board Minutes, 1995-1997 including minutes from 5/2/96.

⁵⁸ See V&E Report, pages 124-125: “We were told that from time to time, a “play-off” occurs in which a City member of the working group [Financing Services Managers] resists disclosure counsel’s comment based on the advice of a different disclosure counsel in a contemporaneous or prior transaction, for instance, that another disclosure counsel did not raise the issue or affirmatively stated that it was unnecessary.”

⁵⁹ See various court cases cited in Investigation for the Board of Administration of the San Diego City Employees’ Retirement System Legal Analysis and Conclusions Prepared by Reish, Luftman, Reicher & Cohen, dated 1/20/06 by Navigant Consulting, including page 45 of 127.

*policy...such a method does not secure scheduled contributions that are connected to the costs of benefits accrued for city employees in any given year (i.e. this method fails to connect the City's cost of contributions to services rendered by employees in a year.)"*⁶⁰

To the extent that funding ratio benchmarks are used to measure the adequacy of funding, Federal tax law uses 125% funded ratio to determine if there is sufficient funding to divert funds from a retirement system and ERISA uses 99% funding ratio to determine when additional contributions must be made to certain private sector plans.⁶¹

The Fiscal Year 2007 contribution of \$162 million does not comply with the above definition, any of the elements of actuarial soundness, or the important principle of Intergenerational Equity.

XV. THE CITY IS REQUIRED TO MEASURE AND FULLY DISCLOSE THE "ANNUAL REQUIRED CONTRIBUTION" (ARC) AND THE "NET PENSION OBLIGATION" PURSUANT TO GASB 27 & 25

While GASB does not speak to the *illegality* of intentional underfunding, leaving that issue to federal, state and local law, it does speak to the requirements of a municipality and its retirement system to *fully disclose and report* the true magnitude of the intentional underfunding (via the APC, ARC and NPO) and its impact on the current and future financial condition of SDCERS and on the City of San Diego's Budget. This is done by the accurate and compliant calculation and disclosure of the Annual Pension Cost, Annual Required Contribution and the resulting Net Pension Obligation "NPO".

GASB is enforced through the auditing process. The consequence for failure to recognize and report irregularities falls on the auditors.

The Council should understand all aspects of the City's Annual Pension Cost including The Annual Required Contribution (ARC) and the Net Pension Obligation (NPO).⁶²

GASB is the yardstick of appropriate behavior not "deals" with the retirement system or phony numbers agreed upon for other purposes.

The contribution amounts historically - and now currently - being used by SDCERS' and the City in various reports and financial statements have *not* been the GASB defined "Annual Required Contributions" (ARC). The contribution amounts excluded certain benefits that were being paid among other irregularities. SDCERS and the City now use terms like "*actuarially calculated contributions*" or "*actuarially determined contributions*", including the \$162 million number, to suggest they are GASB's "Annual

⁶⁰ See page 12 of the 6/12/02 Hanson Bridgett Robert Blum letter to SDCERS.

⁶¹ See page 12 of the 6/12/02 Hanson Bridgett Robert Blum letter to SDCERS.

⁶² For accounting purposes there is also a "technical adjustment" to the ARC, see GASB Statement No. 27.

Required Contribution” instead of the manipulated numbers used to produce artificially low contribution amounts for political and perhaps other reasons.

Certainly during the entirety of the previous administration, the City’s annual pension contributions have not included either principal payments or the interest on the deficit nor have the annual pension costs (APC) been accurately expensed, recognized or reported as required by GASB.⁶³

The City, as the employer, is still “*required to measure and disclose an amount for annual pension cost (APC)*”⁶⁴ according to GASB Standards including the Annual Required Contribution (ARC) and the Net Pension Obligation (NPO) notwithstanding the fact that the current SDCERS Board and “new” actuary have followed in the footsteps of the former Board and former actuary by providing the City with “contribution relief” just for budgetary purposes by using the guise of the Gleason settlement’s non-compliant actuarial methods as the *legal reason*.

XVI. GASB 25 & 27

The Government Accounting Standards Board (GASB) Statements No. 25 & 27 are:

⁶³ The Pension Reform Committee (PRC) recommended the fiscal year 2005 the contribution (for the then underestimated \$1.167 billion UAAL) be at least \$202.67. This was just to *contain* the deficit and included \$93.3 million in interest (not clear whether that was interest on the NPO or interest on the UAAL) and \$33.3 million in contingent benefits previously paid from the “surplus” earnings for a total, along with other accrued costs. This figure did not include any monies to reduce the UAAL. See City of San Diego Pension Reform Committee, Final Report, September 15, 2004, page 9. However, the City ignored the PRC recommendation and contributed only \$130 million using the Gleason settlement (MPIII) as the new guise for intentional underfunding just to accomplish budgetary relief. (Note the requirement of payment of the full annual pension cost (APC) was not presented to the Superior Court Judge approving the Gleason agreement. It should be noted that while none of the law firms were asked to specifically review the Gleason settlement because of the reserved intent of both SDCERS & the City to use it as the MP-III “vehicle” to justify continued illegal and intentional underfunding – Hanson Bridgett did opine it was illegal (See Memorandum of Points and Authorities In Support of Application for Determination of Good Faith Settlement, Section IV, Item B, 3 dated 2/23/05, by Hanson Bridgett). Perhaps not surprisingly, the SDCERS Board passed a bizarre resolution, which was read by SDCERS Board President Frederick W. Pierce, IV prior to voting on the Gleason private lawsuit settlement. The resolution unilaterally purported to “abrogate” California State Government Code Section 1090. The Reish firm did make an opaque reference to the settlement’s illegality when it noted multiple times: ⁶³ “*To the extent an underfunding exists as a result of the MP1 Funding and MP2 Funding arrangements **that were not corrected** in connection with the Gleason settlement, the Board is obligated to collect from the City of the difference between the contributions actually made and those that should have been made had SDCERS been funded on an actuarially sound basis, plus lost earnings on those contributions.*”

⁶⁴ See GASB Summary of Statement No. 27 at www.gasb.org.

- “...intended to make the information in governmental pension plans’ financial reports easier for boards of trustees, sponsoring employers, plan participants, public officials, voters, creditors and investors to understand and use.”⁶⁵

According to the City’s current outside bond disclosure counsel, compliance with GASB standards is not sufficient for disclosure purposes; however, it does provide guidelines to disclose the City’s pension system liability.

GASB Statement No. 27 (which applies to the City’s Financial Statements) and GASB Statement No. 25 (which applies to SDCERS’ Financial Statement) require calculating the "Annual Required Contribution" (the ARC). The ARC is the amount the City owes each year to its pension system using appropriate actuarial methods. Contrary to the current Actuary’s and Retirement System Administrators statements, the ARC has not been calculated in accordance with GASB 25. Certain liabilities were not included in the calculations and certain assets were excluded.

The City must also report the Net Pension Obligation (NPO) which is the *difference* between what the City *should* have put in (the ARC) and what it actually did put in (under MP-I, MP-II or the Gleason Settlement).

So, the City has to report the following 3 numbers on its financial statements:⁶⁶

1. The “**Annual Required Contribution**” (ARC):
 - “Normal Cost” and
 - Annual payment to amortize the deficit⁶⁷
2. The “**Net Pension Obligation**” (NPO)
3. **One year’s Interest on the NPO**

XVII. THE NET PENSION OBLIGATION

The NPO was required to be reported on the City’s financial statements beginning in 1996 *BUT* it has to be calculated going back to the year **1986**. GASB is clear that the *calculation* of the NPO must begin *as of 1986*. (Draft Notes to the 2003 Financial

⁶⁵ See BULLETIN, The Segal Company, March 1995, re: “GASB’S FINAL REPORTING AND DISCLOSURE RULES FOR GOVERNMENTAL PENSION PLANS CHANGE ACCOUNTING PRACTICES SIGNIFICANTLY”, page 1.

⁶⁶ GASB 27 states that the City is “required to measure and disclose an amount for annual pension cost (APC)...Annual pension cost (APC) should be equal to the employer’s annual required contributions (ARC) to the plan, unless the employer has a net pension obligation (NPO) for past under- or overcontributions.”

⁶⁷ According to GASB 25 and 27, the amortization schedule used to calculate the ARC should ensure “Interperiod equity” so that the benefits granted to one generation of employees is paid for by that generation of employees and taxpayers and is not pushed off onto future generations. At this point in time, for the benefits that were granted over the past 15 years to be paid for in a manner that supports Interperiod equity, the UAAL needs to be amortized on a 15 year fixed schedule that concludes in 2021. This was confirmed by the new SDCERS actuary at the March 17, 2006 SDCERS Board meeting.

Statements regarding the NPO prepared by the City of San Diego appear to contain incorrect, understated calculations for the NPO that do not go back to 1986.)

The NPO is a cumulative number. So, the NPO for year one is carried forward to years two, three, four etc. GASB is clear that governments (like San Diego) that may *not have ever calculated the correct ARC*⁶⁸ must go back to 1986 and calculate both the ARC and the resulting NPO.

The City of San Diego has not accurately reported its ARC or NPO.⁶⁹ The City of San Diego created an NPO in the 1980s and 1990s in several ways including, but not limited to:

- By siphoning off pension trust assets to pay annual retiree health care costs from the pension contribution from 1983 through 2005.⁷⁰ (The health care “costs” paid by SDCERS should be audited as they may have been materially larger than disclosed).⁷¹
- By inconsistent use of actuarial methods just to lower contributions (such as switching from EAN to PUC and restarting a new 30-year amortization period in 1991⁷² and again in 2004)

⁶⁸ The Former SDCERS actuary who was employed by SDCERS from 1992-2005 admitted on the record that he had never calculated the “ARC”.

⁶⁹ Without the accurate ARC, there can be no calculation of the accurate NPO because the NPO is the *difference* between the ARC and what the City actually contributes. See page 100 of the Navigant Report, *"The actuary included the GASB 25 comparison in the 1996 actuarial report which was the first year requiring this disclosure...The actuary did not include this comparison in any years after 1996."*

⁷⁰ See *Report on Investigation The City of San Diego, California's Disclosures of Obligation to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices 1996-2004 with Recommended Procedures and Changes to the Municipal Code* dated September 16, 2004, by Paul S. Maco and Richard C. Sauer of Vinson & Elkins L.L.P., Washington D.C., page36-38.

⁷¹ See SDCERS Staff report dated 6/7/05 re “Retiree Health Insurance Out of Area Contracts” and SDCERS Staff report dated 10/4/04 re: SDCERS Retiree Group Health Insurance Enrollment. These reports confirm that *“As of August 1, 2004 the total number of providers is 12, plan types is 79, and enrollees is 3,325.”* They also note that SDCERS pays for “Health Insurance” for 2470 enrolled in City Sponsored plans, 725 enrolled in union sponsored plans and that there are 32 “Outside Contracts”.

⁷² See V&E report, page 38: *“In 1991, for example, the SDCERS Board approved a change in the method of calculating the System's annual cost. The annual cost consists of two components: (1) the actuarial present value of the pension benefits and expenses allocated to a particular year and (2) the amount necessary to amortize the portion of the actuarial accrued liability...Until this time, SDCERS had utilized the EAN method for determining the System's annual cost...SDCERS, however chose to migrate from EAN to the PUC method...Jack McGrory, San Diego's City Manager at that time, explained...the change in method was intended to reduce City contributions to SDCERS at a time of intense pressure on the City's General Fund. SDCERS administrators have confirmed that there was no purpose for the switch in methods other than to provide temporary contribution relief to the City...In addition, as of June 30, 1991, the City reset the period for the amortization of its UAAL. The amortization period remained 30 years, but was restarted from that fiscal year-end. The result was to stretch out the period for the amortization of the*

- By using incorrect data, such as including the DROP money as part of the annual contribution and miscounting assets belonging to the Port as belonging to the City, and
- By intentional underfunding “deals” such as MP-I, MP-II and MP-III also known as the Gleason settlement.

XVIII. THE ANNUAL REQUIRED CONTRIBUTION

To comply with GASB, the Annual Required Contribution should be calculated using GASB recommended parameters and include all benefits being paid and all assets in the plan.

The use of unrealistic actuarial numbers has been a deliberate effort by the SDCERS Board and the City to hide the growing deficit for the benefit of the City budget as noted by Vinson & Elkins:

“...the City took advantage of certain vagaries of 'actuarial science' and pension accounting to further minimize its contributions to SDCERS.”⁷³

Navigant Consulting commented on the need to use actuarial methodologies approved by GASB:

*“GASB Statement No. 25 and 27 provide for a consistent measurement of related information about defined benefit pension plans, including the employer’s ARC and the plan’s funded status, in financial reporting by plans and their sponsors. **These measurements are based on the use of an actuarially sound funding methodology.** GASB Statements No. 25 and No. 27 establish a set of parameters, or criteria, that a plan’s funding methodology is required to meet in order for the information produced by the methodology to be acceptable for financial reporting purposes. If a plan’s funding methodology falls within those parameters, the information produced by the funding methodology is required to be used for financial reporting as well as for funding. If it is not used for funding purposes, disclosure should be made in the retirement plan’s CAFR that an amount less than the ARC is being funded”.*⁷⁴

XIX. CONTINUAL RESTARTING OF 30 YEAR AMORTIZATION IS JUST ANOTHER NUMBERS TRICK USED BY SDCERS AND THE CITY TO ARTIFICIALLY LOWER CONTRIBUTIONS AND UNDERSTATE THE FINANCIAL LIABILITIES

UAAL, thus reducing that component of the ARC. Again, there appears to have been no purpose for this action other than to reduce the City’s contributions to SDCERS.”

⁷³ See V&E Report, page 5.

⁷⁴ See Navigant Report, page 106 of 115.

According to page 32 of the Navigant report:

"Unfunded liabilities are typically funded over a specific time period. Thirty years is traditionally the longest period used for pension funds. The thirty years is approximately equal to the average time between the date of hire and the date of retirement."

While GASB supports a ***one-time*** 30-year amortization of the UAAL, it does not support the inconsistent practice of routinely and sequentially re-amortizing to new 30 year fixed schedules just to lower contributions. This is what has happened in San Diego. Debt in existence in the 1960s was refinanced to a new 30-year fixed amortization in 1991 which was then refinanced to a new 30-year fixed again in 2004 only to provide contribution relief in exchange for or to preserve benefit enhancements.

Vinson & Elkins noted that this practice of continuing to re-amortize the debt was done for no other reason than to artificially reduce contributions and push the cost onto future generations.⁷⁵

In 2004 as part of the *Gleason* settlement, the 30-year amortization schedule begun in 1991 was ***again*** re-amortized again even though there were 17 years remaining.

The current SDCERS actuary suggested at the March 17, 2006 SDCERS Board Meeting that for benefits granted in the past 10 years to be paid by the generation receiving those benefits the system should be using a 15 yr. amortization for that debt. Under that accurate and legally compliant methodology the City's contribution would jump from the approximate 27% of payroll to about 40%, which is why there is such resistance to using it.

XX. USE OF AGGRESSIVE ACTUARIAL METHODS SHOULD NOT BE TOLERATED PARTICULARLY GIVEN SDCERS' HISTORY OF FINANCIAL MISMANAGEMENT AND THE UNFUNDED STATUS OF PLAN

In addition to the outright loan of pension funds to the City, SDCERS has historically used many aggressive and 'stale' assumptions just to provide near term contribution relief and to push the cost onto future generations including but not limited to the use of:

- artificially low payroll numbers,⁷⁶

⁷⁵ See page 38 of the Vinson & Elkins report.

⁷⁶ Accurate payroll numbers should be used to calculate the Annual Required Contribution. SDCERS staff confirmed at the 3/17/06 Board Meeting that payroll numbers being used to calculate the pension contributions may not be accurate and may have been artificially low. No one has been able to reconcile the payroll number being used to calculate the pension contributions with the City's budgeted payroll. This was noted by the Pension Reform Committee, by former SDCERS Trustees and by current SDCERS Trustees such as Trustee Shefler. This is extremely important since the entire system is based on contributions as a percent of payroll. If the actuary is using an artificially low payroll number, the

- artificially high assumed rate of return (the assumed rate of return should be lowered to 7.75% at least),⁷⁷ and
- several other aggressive actuarial assumptions such as inappropriate employee turnover numbers, inappropriate mortality tables, etc.

In addition, other irregularities have occurred such as a portion of the UPD's (the Port) assets have been miscounted as belonging to the City thus inflating the City's funded ratio⁷⁸ and DROP contributions have been erroneously included as part of the City's (or City employees') required contributions, to name a few.

XXI. SDCERS OUTSIDE AUDITOR BROWN & ARMSTRONG FINDS MATERIAL WEAKNESSES, LACK OF INTERNAL CONTROLS, FINANCIAL MISMANAGEMENT

In a 2005 report entitled *Communication of Reportable Conditions to the Retirement Board and Management* SDCERS outside auditor Brown and Armstrong raised an alarming number of material items relating to the SDCERS 2004 Financial Statements, including the legitimacy of SDCERS numbers, investment returns and a dangerous lack of internal controls. The items listed below range from an incomplete general ledger to everyone who retired before January 1, 2002 is carried on the SDCERS books as being hired on the same date: November 11, 1911 - that's 91 years ago.⁷⁹

“Material Weaknesses” identified in the report by Brown and Armstrong:⁸⁰

- Finding 1 - SDCERS does not maintain a complete general ledger
 - Accounts are not reconciled to subsidiary reports such as: contributions from the City, Port or Airport Authority, employee offset accounts, benefits, health insurance payments, death benefits, DROP payments, and refunds, to name a few.

contributions will be artificially low. In 2004, there was an approximate 12% difference of \$535 million being used by SDCERS actuary and the City's budgeted payroll number of over \$600 million. At the March 17, 2006 Press Conference, the Mayor said he was confident in the City's payroll numbers. Those payroll numbers should be used to calculate the APC.

⁷⁷ Both Mercer, the SDCERS independent auditor hired to "review" the actuary, and former SDCERS actuary recommended the assumed rate of return be lowered from 8% to 7.75%.

⁷⁸ One example of this: \$5 million of the Port's assets were included in the City's assets in the SDCERS FY June 30, 2001 Annual Actuarial Valuation which if removed would have caused the City's funded ratio to drop from 89.9% to 89%.

⁷⁹ See Union Tribune Article by Jennifer Vigil dated 9/22/05, *Memo Shows System In Shambles*. In this article SDCERS former General Counsel Lori Chapin is quoted as saying: "We agreed with every single one of their findings."

⁸⁰ A “material weakness” is a significant deficiency, or a combination of significant deficiencies, that result in “more than a remote likelihood that a material misstatement of the annual financial statements will not be prevented or detected”. – See Public Company Accounting Oversight Board Auditing Standard No. 2.

- Finding 2 - SDCERS “pools” its cash with the City’s cash. But, it does not prepare monthly bank reconciliations to ensure that the cash that is supposed to be in the SDCERS Fund is actually there. In fact, there has been no reconciliation of the SDCERS cash with the City’s cash since June of 2003.
 - SDCERS CAFR dated June 30, 2003 page 103 reflects \$312,044,538 million in “Cash & Cash Equivalent Holdings”.⁸¹
- Finding 7 - SDCERS Wire transfers of money out of the pension system to the City for retiree payroll occurred without written documentation or reconciliation.
- Finding 15 - SDCERS has no formal policy for writing checks or spending money.
 - Apparently, it’s pretty easy to write checks off of the SDCERS account. There is no approval necessary. There is no process that has to be followed. No invoices need to be kept.
- Finding 20 – SDCERS “journalled” or “transferred” significant amounts of money incorrectly and the transfers have not been subjected to a secondary review. When asked by the auditor why there was no secondary review, SDCERS staff “indicated that approval...was not needed.”

Here are some of the concerns related to investments:

- Finding 12 - SDCERS does not engage an independent third party to price the individual securities (stocks, bonds, and real estate).
 - When I was on the Board Retirement System staff virtually fabricated some of the investment values, including inflating one asset by more than 20% or \$40 million.
- Finding 8- SDCERS Investment Staff does not prepare a comprehensive list of money movements between managers, nor do they reconcile these money movements.
 - SDCERS supposedly has a “rebalancing investment program” by which staff moves large sums of money between investment managers. However, SDCERS Staff does not prepare a comprehensive list of money movements between investment managers. And, they don’t check to see if the money got there.

Other audit concerns:

⁸¹ This was considered a “Material Weakness” and “has resulted in a Qualified Opinion” to be issued on the June 30, 2004 SDCERS financial statements. See Finding 2)

A “qualified opinion” results when there has been an auditing scope limitation (See Public Company Accounting Oversight Board Auditing Standard No. 2)

- Finding 14 - Employees no longer with SDCERS are still listed as authorized signatories.
- Finding 3 & 5 - SDCERS is unable to locate certain participant files and SDCERS does not obtain appropriate records from all participants, such as:
 - Birth Certificate
 - Marriage Certificate
 - Spouse's Birth Certificate
- Finding 9 -During the inquiry and analysis of the risk of fraud within SDCERS it was noted that a Code of Ethics policy does not exist.
- Finding 23 - The June 30 reserve balances are consistently understated and the Undistributed Earnings Reserve is consistently over stated.
- Finding 6 – In the identification of deceased participants it was noted that: “Although outside the scope” of their audit, it was brought to their attention that as a result of the 2001 Death Match Audit “there are currently 63 members whose file are still under review as to their status.”
 - You'd think in 5 years SDCERS would be able to figure out if these people are dead or alive and how much money they actually received.

XXII. SDCERS DOES NOT COMPLY WITH INVESTMENT REPORTING STANDARDS AND HAS USED INCORRECT PERFORMANCE PRESENTATION INFORMATION IN ITS QUARTERLY INVESTMENT MONITORING REPORTS AND IN ITS COMPREHENSIVE ANNUAL FINANCIAL REPORTS (CAFR) FOR AT LEAST SEVEN YEARS

To the extent that SDCERS has "pooled" its cash with the City (as noted by Brown & Armstrong) and to the extent that this cash was managed by an investment manager, the quarterly investment monitoring reports do not appear to reflect this portion of the SDCERS portfolio. These quarterly monitoring reports were prepared by the SDCERS investment consultant, Callan & Associates.

There may be other irregularities in the Callan investment performance reports, including but not limited to items such as the use of inaccurate data for the market values of investments, inappropriate indexes for comparison purposes, incorrect performance calculations, incomplete portfolio information, and other items mentioned in my June 7, 2002 letter to former SDCERS Trustee Richard Vortmann with copies to the SDCERS Board and former Mayor Dick Murphy.

While SDCERS has repeatedly claimed “stellar” long term investment performance it is of note that the investment portfolio has ***not*** been comprehensively audited since at least 1991. (Mercer said it only reviewed one or two Callan reports for two years (2002 and 2003); they only looked at few investment managers; and they were unfamiliar with a certain errors and market value discrepancies.)

In addition, the serious issues raised by Brown and Armstrong make it difficult to understand how any legitimate investment returns could have been calculated given there is:

- No third party, independent “quote” system for investment values (I have seen staff just make them up),
- *No monthly or even yearly reconciliation* of hundreds of millions of dollars allegedly held in cash and “pooled with the City”,
- *No monthly* reconciliation of hundreds of millions of dollars allegedly moved from one investment manager to another,
- *No written documentation* for hundreds of millions of dollars moved out of SDCERS account to the City,
- No total portfolio investment performance calculations that reflect the impact of the large external cash flows resulting from the City’s contributions or the System’s alleged “Rebalancing” program.

SDCERS CAFRs incorrectly claim compliance with industry standards by making the following claim: *"The performance calculations were made in compliance with AIMR Performance Presentation Standards."*⁸²(Emphasis added.) However, SDCERS calculations are *not* made in compliance with AIMR Standards, GIPS Standards or any industry standards. A recent nationwide article that noted these types of claims are made as an "assertion of verification or authenticity that the performance numbers should or need not be questioned."⁸³

This claim by SDCERS is an incorrect usage of the Association of Investment Management & Research’s Portfolio Performance Standards (AIMR-PPS) and the certification is contrary to performance report requirements of global investment performance standards and those of the Association for Investment Management and Research, which issued the performance presentation standards.⁸⁴

XXIII. WITHHOLDING OF INFORMATION REGARDING THE AMOUNT OF THE TRUE ANNUAL REQUIRED CONTRIBUTION, NET PENSION OBLIGATION AND IMPACT ON CURRENT AND FUTURE ANNUAL BUDGETS MISREPRESENTS BY OMISSION THE TRUE FINANCIAL CONDITION OF THE CITY AND ITS RETIREMENT SYSTEM

Legal opinions provided by firms such as Vinson & Elkins and Orrick note:

⁸² See Page 58 of the SDCERS CAFR for FY ended June 30, 2002 and Page 82 of the SDCERS CAFR for June 30, 2003.

⁸³ See page 12 and page 35 Letters to the Editor, by Brian C. Briedenbach, Pensions & Investments, 3/6/06.

⁸⁴ See "Misleading Compliance, Public Pension Funds Misuse Performance Reporting Standards, Even If Return Data Are Accurate" by Brian C. Briedenbach, Pensions & Investments, 1/9/06, page 12.

- Public entities issuing municipal securities are liable for the content of public disclosure (including the public discussion of this pension contribution issue and official action taken) and are subject to the anti-fraud provisions under the federal securities laws against false and misleading statements.
- Public entities are required to provide the public and Capital Market's with information that, taken as a whole, represents a fair and accurate picture of the issuer's financial situation. The SEC has taken the position that a municipal issuer is required to disclose material information concerning financial obligations, even if they cannot be estimated with precision.⁸⁵
- To the extent that there is any doubt cast or questions raised about the City's pension information City officials are under a duty to make further inquiry.
- The issues raised in this letter cast doubt and raise questions as to the legality of:
 - continuing to intentionally underfund the pension plan in FY 2007, and
 - withhold material information by omission regarding the true Annual Required Contribution and Net Pension Obligation from the public discussion of the Fy2007 pension contribution.

The United States Securities and Exchange Commission has stated:

“...public officials of the issuer who have ultimate authority to approve such municipal securities and related disclosure documents may not authorize disclosure that the public official knows to be false; nor may a public official authorize disclosure while recklessly disregarding facts that indicate there is a risk that the disclosure may be misleading.”⁸⁶ (Emphasis Added.)

XXIV. QUESTIONS FOR THE AUDIT COMMITTEE

Finally, I have the following questions which would be helpful for the Audit Committee to clearly answer:

- Is it ok to calculate pension contributions based on assumptions that are “negotiated” in settlements by parties who do not have as their primary objective the correct funding of the pension system; but rather have their own economic interests in mind?
- Is it ok to balance the budget by incurring debt to the pension system?

⁸⁵ See Massachusetts Turnpike, Securities Act Rel. No. 8260__, 361.

⁸⁶ See County of Orange, California, Exchange Act Rel. No. 36761 (1/24/96), 61 SEC Docket 487.

- Is it ok to defer annual required pension contributions into the future? If so, how many years or decades may the City defer payments? May the City intentionally underfund for an indefinite period of time?
- May the City take contribution holidays to the pension system when payments are delayed one or more years?
- May the City make deficient contributions with a balloon payment owed in the future? If so, how many years may the City defer the balloon payment?
- Can the City receive a loan from the Pension System? If so, what is the maximum amount? What is the maximum time frame for repayment for the loan?
- Is it ok for the Council to rely on the SDCERS actuary for the calculation of the annual required contribution even if questions exist regarding the fact that the calculated contribution amount is deficient and underfunds?
- Should the City hire an actuary to determine the appropriate calculations if there are questions regarding the reliability and motives of SDCERS and its actuary?
- What other payments may the City defer indefinitely into the future besides the pension contribution?
- Is it ok for the City to create debt with no known source of revenue for funding? If so, what is the maximum amount of debt that may be created this way? Is the amount unlimited?
- What are the standards of disclosure for the City Council when it knowingly and intentionally underfunds the pension system?

Respectfully,

Diann Shipione
Former SDCERS Trustee

Cc: Audit Committee of the City of San Diego – Kroll
City of San Diego Outside Auditors KPMG & Macias Gini & Co.
City of San Diego Auditor & Comptroller John Torell
SDCERS Outside Auditor Brown & Armstrong
San Diego City Attorney Michael Aguirre

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