

REPORT 2012-106 SUMMARY - AUGUST 2012

City of San Jose: Some Retirement Cost Projections Were Unsupported Although Rising Retirement Costs Have Led to Reduced City Services

HIGHLIGHTS

Our audit of the City of San José's retirement costs highlighted the following:

Some of the retirement cost projections reported in the city's official documents in 2011 were not supported by accepted actuarial methodologies.

- Three bond statement documents that disclosed its financial condition to potential creditors used an inadequately supported projection that its annual contributions toward retirement costs would increase to \$400.7 million by fiscal year 2015-16.
- A projection that the city's annual retirement costs could increase to \$650 million by fiscal year 2015-16 was unsupported and likely overstated.
- The actuary for the boards of the two retirement plans projected that the city's fiscal year 2015-16 retirement contribution would be \$320.1 million.

The city's actual retirement costs increased significantly from fiscal years 2009-10 through 2011-12, causing annual pension costs to double.

Costs related to postemployment health benefits for retirees enrolled in both plans rose by approximately 66 percent over the last four fiscal years.

As a result of the significant growth in costs related to police and fire retirement benefits from fiscal years 2009-10 through 2011-12, budgeted general fund public safety expenditures increased, even though the average number of actual filled full time equivalent positions in this area declined by 382.

RESULTS IN BRIEF

During fiscal years 2009-10 through 2011-12, the City of San José (San José), the State's third most populous city, experienced financial challenges as its budgeted revenues declined and retirement costs—consisting of pension and postemployment health benefits—increased. Although we believe that San José's financial challenges are real, we found that some of the retirement cost projections reported in the city's official documents in 2011 were not supported by accepted actuarial methodologies, nor were the underlying assumptions vetted and approved by the boards of administration of the city's two retirement plans—the Federated City Employees' Retirement System (federated plan) and the Police and Fire Department Retirement Plan (police and fire plan).

For example, San José used one inadequately supported projection that its annual contributions toward retirement costs would increase to \$400.7 million by fiscal year 2015-16 in three bond statement documents that disclosed its financial condition to potential creditors. In addition, in supporting the need to reduce retirement benefits, the mayor and certain city council members referred to a projection that the city's annual retirement costs could increase to \$650 million by fiscal year 2015-16, a projection that our actuarial consultant determined was unsupported and likely overstated, when assumptions approved by the boards of the two retirement plans are considered. Using the most recent assumptions approved by the two boards, the boards' actuary projected that the city's fiscal year 2015-16 retirement contribution would be \$320.1 million, which is less than half of the unsupported \$650 million projection. Further, in June 2012, city voters approved a measure that, if it survives pending legal challenges, would authorize reduced future pension benefits for current city employees who do not increase their retirement contributions. The measure also requires San José to adopt new retirement plans for new city employees, and it limits the benefits that can be offered under the plans. Reporting multiple retirement

cost projections in a short period may have caused confusion among the city's stakeholders attempting to make informed decisions. For instance, it is unclear which retirement cost projection the voters relied on, if any, when they voted for these changes.

Although we have concerns with some of San José's projected retirement costs for future years, the city's actual retirement costs increased significantly from fiscal years 2009-10 through 2011-12. For example, during this period, San José's annual pension costs doubled, driven in part by investment losses experienced by its two retirement plans. Moreover, primarily because of differences in the way the two retirement plans spread their actuarial losses over time, annual pension costs associated with the police and fire plan increased significantly more than the costs of the federated plan. Further, the city's actuarially determined costs related to postemployment health benefits for retirees enrolled in both plans rose by approximately 66 percent over the last four fiscal years. As of fiscal year 2010-11, San José's unfunded obligations for both plans' pension and postemployment health benefits were \$1.5 billion and \$2 billion, respectively.

These rising retirement costs and declining budgeted revenues have created budgetary challenges for San José. For example, as a result of the significant growth in costs related to police and fire retirement benefits from fiscal years 2009-10 through 2011-12, budgeted general fund public safety expenditures increased, even though the average number of filled full-time equivalent positions in this area declined by 382. Thus, San José may be providing reduced services at an increased cost. Moreover, these increased costs appear to have crowded out some of the funding previously available for services other than public safety, such as parks and libraries.

RECOMMENDATIONS

To ensure that stakeholders receive consistent and reliable information, San José should report the official retirement cost projections that were developed using the assumptions approved by the two retirement plan boards (boards). If San José does not use the official retirement cost projections, it should develop projections that are supported by accepted actuarial methodologies, report this information in the correct context, and disclose significant assumptions that differ from those in the boards' retirement cost projections.

AGENCY COMMENTS

Although San José agreed with our recommendation, it disagreed with how we characterized some of our conclusions.

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