

**SANTA BARBARA COUNTY EMPLOYEES' RETIREMENT
SYSTEM**

SUMMARY

The media has highlighted several large pension funds losses as a result of the market drop in October 2008. It has been estimated that between October 7, 2007 and October 7, 2008 state and local pension plans lost over \$1 trillion.¹ This estimate does not include losses through the end of October 2008. The pattern for the Santa Barbara County Employees Retirement System (SBCERS) is similar. For the first six months of this fiscal year (July 1, 2008 – December 31, 2008) there has been a \$421 million, 24% decline in the value of SBCERS investment portfolio. Recovering from this loss is likely to take several years. While retirement benefits for retired and current employees are essentially guaranteed, there will be a significant impact on the County finances. Public pension plans such as SBCERS assume that the investment growth of the employer and employee contributions will provide the agreed on pension benefits. When the investment growth is less than the expected amount, as has occurred in Santa Barbara, the County is responsible for funding the difference. Although the payment may be spread over a period of years, the size of this particular loss will result in an increasing burden to the County budget that has already been impacted by poor economic conditions. Adding to the problem is the history of the increasing liability of the Retirement System prior to the market drop of October 2008, primarily a result of the poor investment performance of the System.

The 2008–2009 Santa Barbara County Civil Grand Jury believes that the SBCERS should add staff to improve its in-house financial analysis and oversight of its portfolio. If the system cannot achieve better investment performance in the future, continuously increasing pension obligations are likely to require significant changes in the retirement plans as they now exist. At the same time the size of the problem requires the Retirement System to provide short term “Band-Aids” to reduce the immediate impact of this financial tsunami. Longer term solutions would require significant retirement plan changes and require the cooperation of the County, the Retirement System, employee representatives, and possibly modification of the current law under which the System is governed. Some of these changes in the retirement plan, while not affecting current employees, may be required for future employees.

The cost of retirement benefits is an area where there is a large degree of confusion, and, in many instances, resentment. The presentation of the cost of benefit increases at public

¹ Munell, Aubrey, and Muldoon, “The Financial Crisis and State/Local Defined Benefit Plans”, Center for Retirement Research, November 2008

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meetings is unintelligible to most people; it is important for the Board of Supervisors to adopt a policy that presents the rationale and cost of such benefit increases in an easily understood manner. We use the terms “likely” and “expected” throughout the report. Uncertainties associated with the economy and investment returns might result in a very different financial picture a year from now (better or worse). The only thing certain about the future is uncertainty.

BACKGROUND

In recent years public pensions have been the subject of much media attention. In California, some city and county finances² have been severely impacted by their increasing pension system contributions which in some cases have led to bankruptcies. The significant drops in the financial markets worldwide have increased the uneasiness of both the sponsors and beneficiaries of the systems. Taxpayers also question whether increased benefits provided by government will cause significant burdens in the future. To examine the state of the Santa Barbara County Employees' Retirement System (SBCERS), the Grand Jury has conducted this investigation.

METHODOLOGY

This report begins by examining the current funding status of SBCERS, the employer contribution history, the financial performance of the system, its performance with respect to its goals, comparison with its peers and the likely impact of future obligations. The issue of public information regarding employee benefits and their costs is then discussed. Information was obtained from interviews and reports produced by a number of sources. Grand Jury members reviewed reports from other California counties that participate in similar employee retirement systems. National public pension fund results were obtained from Public Fund Survey information and pension consulting firms. Thirteen interviews were conducted with members of the Santa Barbara County Board of Supervisors, County executive management, Retirement Board members, Retirement System personnel, actuarial professionals, and pension investment fund consultants. Grand Jury members also attended Retirement Board meetings. The main sources of the data used were the County Auditor-Controller; the Retirement System investment consultant, Pension Consulting Alliance; and the Retirement System's actuarial firm, Milliman.

² Cities of San Diego, Vallejo

OBSERVATIONS AND ANALYSIS

Santa Barbara County's retirement plan is a defined benefit plan. Defined benefit plans are those in which the employee and the employer each contribute to the retirement fund. On retirement the employee receives a guaranteed defined payment. This is in contrast to a defined contribution plan, where the employee and employer each contribute to the retirement fund, and the employee receives the results of the invested contributions with no guaranteed payment. Defined benefit plans are used by 86% of government agencies, while defined contribution plans are much more common in the private sector.

Santa Barbara County is one of 20 counties in California whose retirement systems were established in conformance with the California Employees Retirement Law of 1937. Members of the system are County and special district employees and retirees. The Retirement Board is responsible for the management and administration of the System. Membership of the board consists of nine voting members, four members appointed by the County Board of Supervisors, four members elected by active or retired members and the County Treasurer-Tax Collector as an ex-officio member. There are two alternate employee representatives who vote only in the absence of employee/retiree members. Santa Barbara County is the sponsor of the retirement system. As the sponsor, it provides the employer contribution to the plan, but has no voice in its administration. The Retirement System is an independent entity from the County government. It is important to note that the Board, in addition to managing the System's assets, has other responsibilities. This report deals only with investment related concerns.

While discussions of pension systems can be confusing, the starting point is based on a simple equation:³

$$C + I = B + E$$

C is the contribution

I is the investment return

B is the benefit

E is the expense

The annual contribution to retirement benefits has two components. One is the Normal Cost, and the other is the Unfunded Actuarial Accrued Liability (UAAL), or unfunded liability. The Normal Cost is the share of the present value⁴ of future retirement benefits plus administrative expenses. Estimating the liabilities associated with these future

³ "Funding Pensions & Retiree Health Care for Public Employees", A Report of the Public Employee Post – Employment Benefits Commission, 2007, page 223

⁴ The present value is the value today of what something will be worth in the future. For example, if you are to receive \$10,000 in five years, the present value of that \$10,000 is something less than \$10,000. If you could earn 5% interest on your money, you could receive \$7,835 today and at the end of five years you would have \$10,000. The \$7,835 then becomes the present value. In the case of a pension, the future benefit is the retirement benefit that will be paid out over many years. The present value of those benefits is defined as "the amount of money needed to be invested today for those benefits to be paid in full in the future."

benefits for a period that may be more than 50 years in the future involves the use of actuarial techniques. These are the same techniques that are used by insurance companies to determine premiums. Instead of trying to estimate the frequency and severity of loss, these estimates deal with expected liabilities and the probabilities associated with a number of employment variables such as length of service, life expectancy, and economic assumptions. Such estimates are generated with the use of both population and historical data, and are known as actuarial estimates. The second component is the unfunded liability. To understand this component, a short discussion of pension fund accounting terms is required.

Retirement systems' assets have two measures of value. The first is the market, or current, value of the portfolio or assets. The second is the actuarial value. The actuarial value is calculated by adjusting the market value of assets by the differences between the actual and expected market returns recognized, or smoothed, over a five-year period. This approach mitigates the impact of year-to-year market fluctuation on evaluating the financial health of the system and determining sponsor contributions. When the current actuarial value of the system assets matches the present value of the expected future liabilities, the system is considered fully funded. In the case where the current actuarial value of the assets exceeds the present value of the projected future liabilities, the system is "overfunded". The system is "underfunded" when these liabilities exceed the assets. This underfunding is the unfunded liability. The payment of the unfunded liability is entirely the responsibility of the County. The unfunded liability is treated in much the same manner as a mortgage, and is typically amortized over a period of time, typically 15 years, but in some cases as long as 30 years. While there are different techniques for treating the amortization schedule, the assumption is that the investment return from the unfunded liability contribution will grow at the same investment rate used in calculating the Normal Cost.

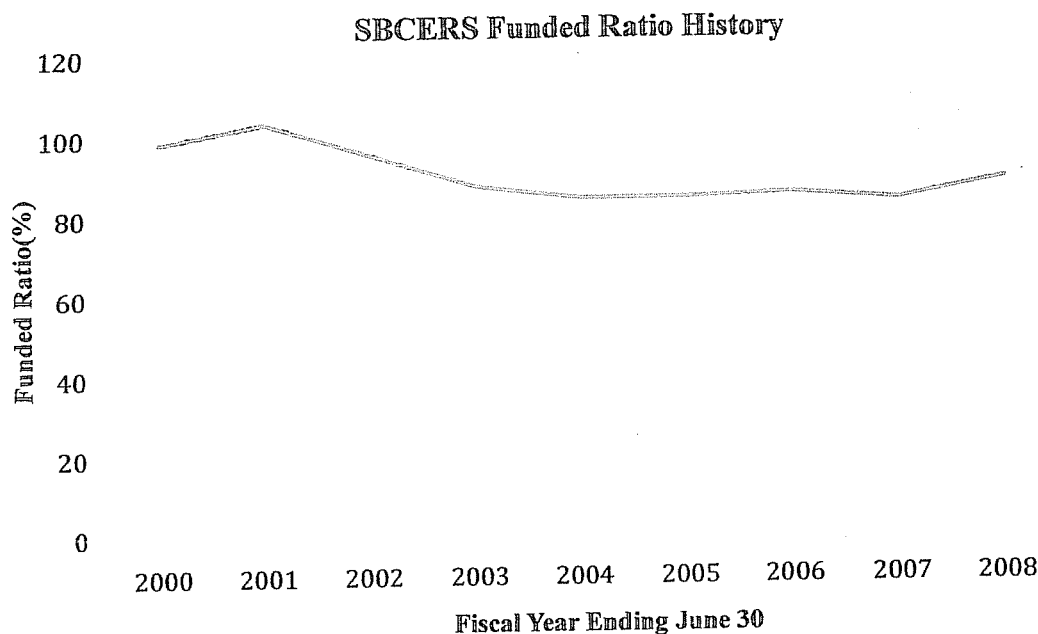
It is important to understand the distinction between the unfunded liability and current obligations of the system. The system with a growing unfunded liability may have more than enough assets to satisfy the obligations to current retirees (as does SBCERS), but it does signify the need for improved investment performance and/or increased contributions to meet obligations to current employees.

As the sponsor of the County Employees' Retirement System, the County is legally obligated to pay an annual required contribution to the System. This contribution is based on the employer's portion of the Normal Cost plus the amortized cost of the unfunded liability. This latter cost is currently amortized over a 15-year period. It is generally expressed as a percentage of the covered employee payroll. While the County and the employee both contribute to the Normal Cost element of the future benefit, as noted earlier the County pays all of the cost of the unfunded liability.

To examine the health of a retirement system a commonly used measure is the ratio of assets to liabilities known as the funded ratio. Using the funded ratio as a starting point we look at the status of SBCERS

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SBCERS Current Status, Future Challenges



This chart⁵ shows that the funded ratio was 98% at fiscal year end 2000, rising to above 100% in 2001. The market drop between 2000 and 2002⁶ led to drops in the funded ratio that continued until fiscal year ending 2005. The upward swing in the funded ratio for fiscal year ending 2008 is the result of a one-time accounting change, which if excluded, would result in approximately the same funded ratio as the previous fiscal year.

While there is no universal agreement on a specific criterion, with a funding ratio of 88.6% at the end of fiscal year 2008, the County system is considered to be well funded. Reviewing the current assets and liabilities of the system, Milliman, the actuarial firm retained by the Retirement Board concluded that the pension fund had the assets to cover all of the current retirees and their beneficiaries, plus 71% of the amount required of the expected future payments for current active members.⁷

A major concern is the growth of Santa Barbara County's required contribution to pay for the unfunded liability. This is shown in the following figure⁸.

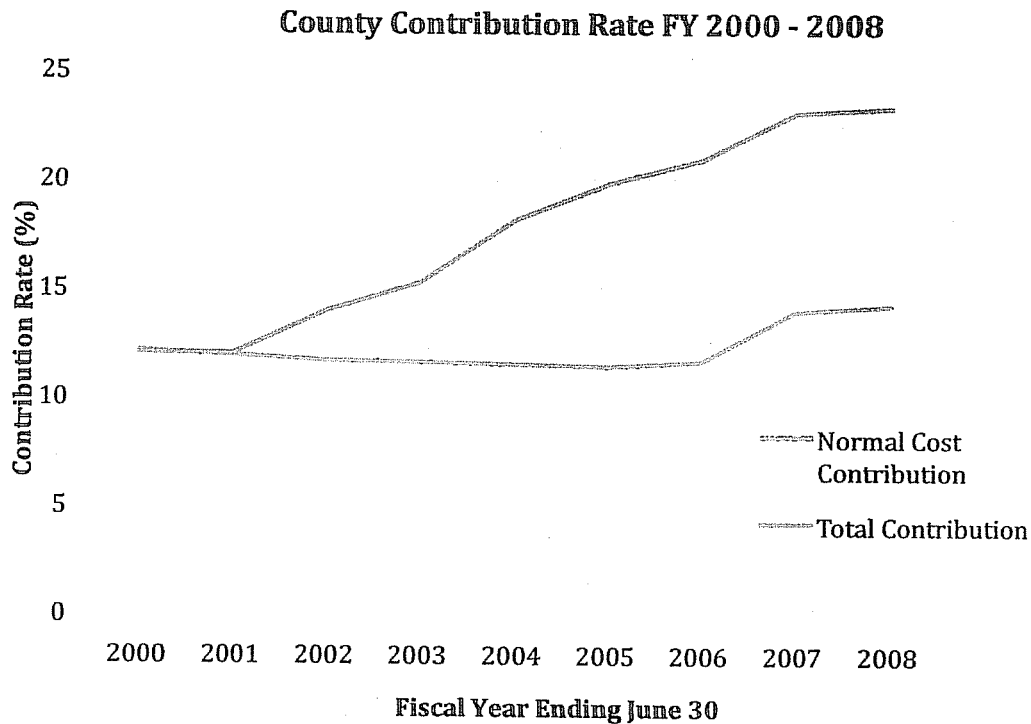
⁵ "Santa Barbara County Employees' Retirement System, Actuarial Valuation", June 30, 2008, Karen I. Steffen and Daniel R. Wade

⁶ The rise in the funded ratio in 2001 is due to the smoothing of investment results which is discussed later.

⁷ See footnote 5.

⁸ See footnote 5. The increase in the Normal Cost contribution rate in fiscal year 2007 is due to an actuarial change and the introduction of a new safety officer retirement plan.

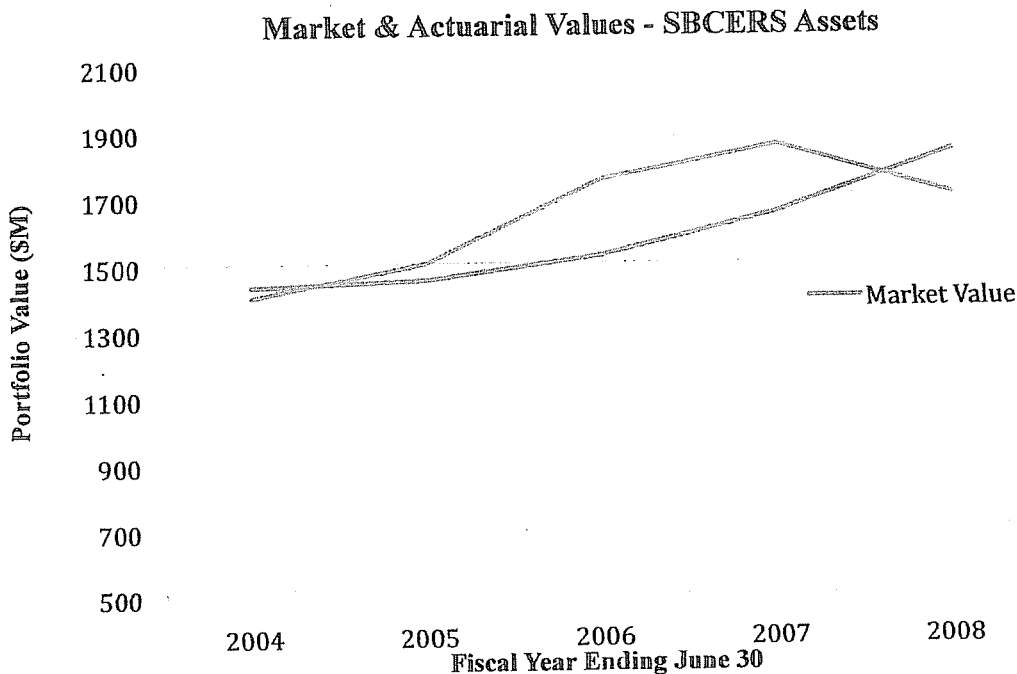
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This chart shows that the County's contribution rate has almost doubled since the start of the decade. In addition to the pension contribution rate, the County contributes 3% of the covered retirement payroll for a retiree health care subsidy, and 6.2% to Social Security (except safety members). The current County annual contribution rate of 23% to the retirement system represents \$57.7 million. A one-percentage point change of contribution rate represents a change of \$2.5 million in the County contribution.

Earlier, the use of actuarial value was mentioned as an approach to minimize unpredictable changes in the pension contribution by the County from one year to the next.

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The actuarial value lags the market value, as seen in the chart above.⁹ The Board has adopted a “corridor” that requires the difference between the actuarial value and the market value to be within 20% of the market value of the assets, which could mean the actuarial value has to be restated so that it falls within the corridor. While in the past this has been merely an accounting footnote, the losses this year will very likely result in the difference between the actuarial and market values of the assets on June 30, 2009 to exceed that threshold. This would require that the actuarial assets be reduced to fall within the corridor. This reduction would increase the unfunded liability and further increase the County contribution.

Recent market losses are likely to have a significant impact on the County’s contribution for a number of years. In the fiscal year ending June 30, 2008 the portfolio decline was \$143.2 million, resulting in a value of \$1.765 billion. Since July 1, 2008 there has been a further loss of value, and the current investment portfolio value (as of December 31, 2008) has dropped to \$1.34 billion,¹⁰ which represents a loss of \$421 million or a 24% decrease from the end of the last fiscal year.

If the value of the investment portfolio at the end of June 2009 remains at or below \$1.34 billion, the unfunded liability would be over \$600 million, more than double the liability of June 30, 2008 of \$242 million. This would lead to even more stress on the County budget beginning in 2010 as the losses are recognized over an extended period. With the growing unfunded liability, the County’s contribution to the Retirement

⁹ See footnote 5.

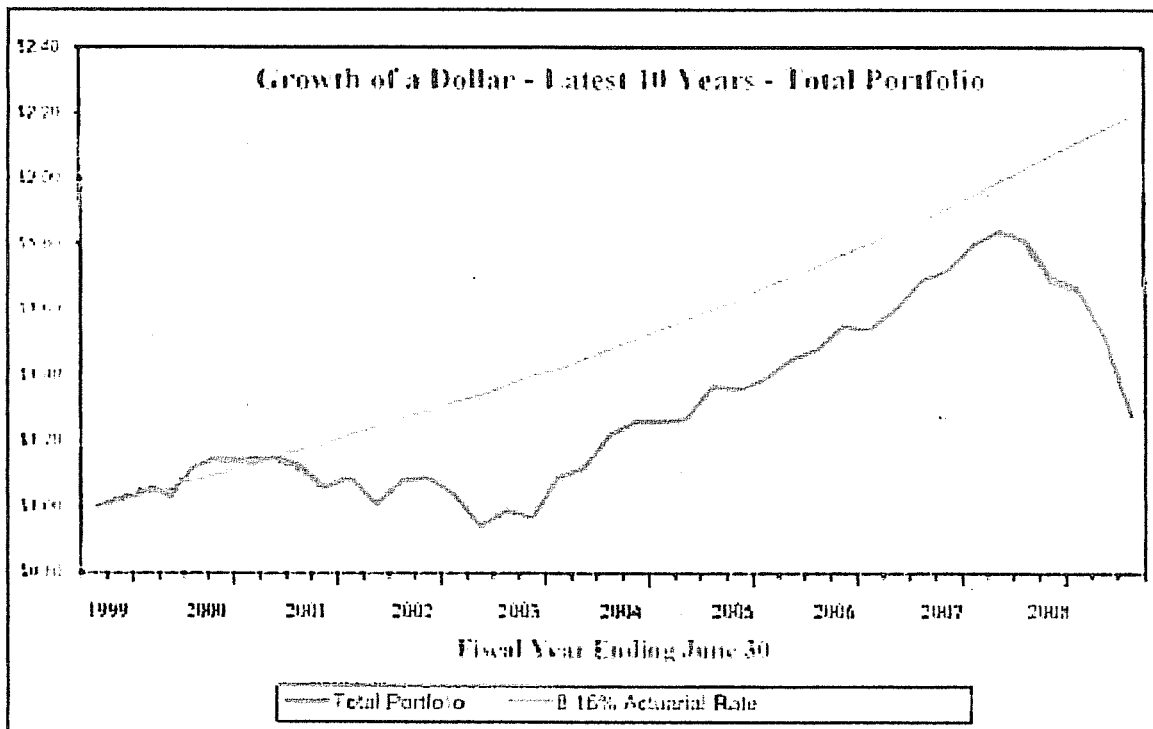
¹⁰ Pension Consulting Alliance, “Santa Barbara County Employees’ Retirement System Investment Portfolio: Quarterly Report Executive Summary” December 31, 2008

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System may exceed 35% of the labor base, and adding health care and Social Security (except for safety members) contributions could result in a total County benefit contribution of almost 45% of the County payroll. Such increases could result in an increased obligation by the County of \$25 million/year to \$30 million/year. Whether that level of cost could be borne without revenue increases, or service reduction is a major concern. There is no certainty in what the future holds for the market conditions, but prudence demands that the County anticipate the possibility of continued financial market weakness. Whatever actions are taken to reduce these impacts, the keystone on which the Retirement System's future depends is its investment performance.

SBCERS Investment Performance

The Grand Jury examined the System's performance by relating/comparing the investment results of its portfolio to its established goals and to that of its peers. In calculating both employee and employer contributions, there is an assumed investment return, or goal, of 8.16%. This return represents the expected long-term return on the investments (the actuarial horizon is on the order of 50 years). A starting point is to look at SBCERS' actual return with respect to that expectation.¹¹

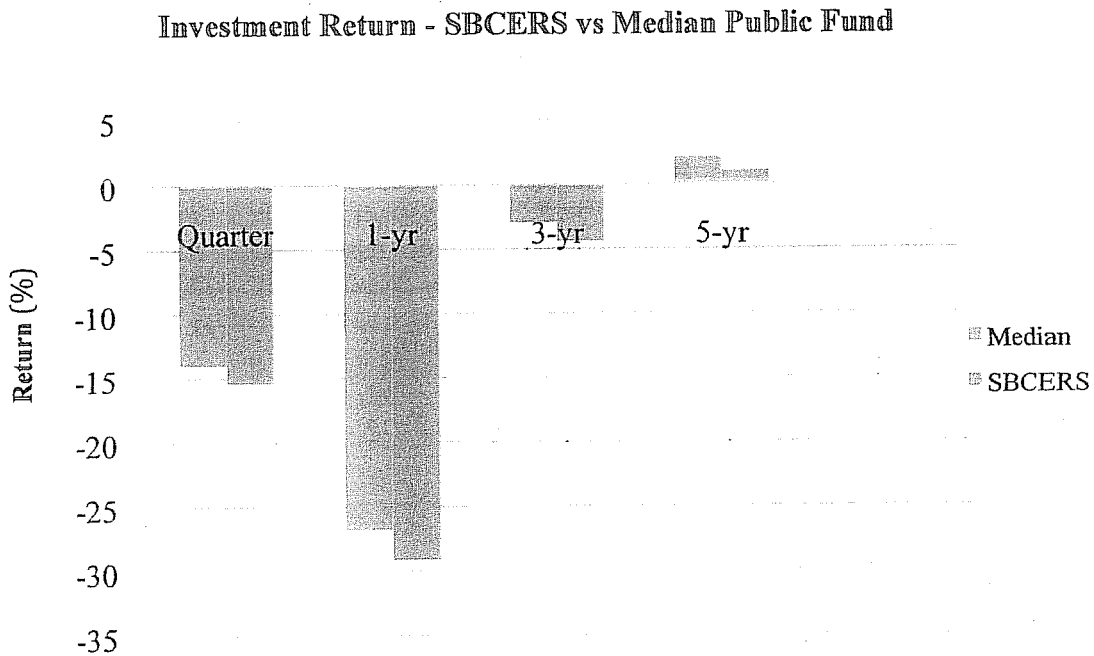


¹¹ "Santa Barbara County Employees' Retirement System Investment Portfolio Quarterly Report, Executive Summary", Pension Consulting Alliance, December 31, 2008

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The actual return for the SBCERS portfolio for the 10-year period ending December 31, 2008 was approximately 2.7%. The impact of the market fall of the last quarter of 2008 can be appreciated by noting that in the previous 10-year history ending in June 30, 2008 SBCERS portfolio return was 5.7%. The gap between the expected cumulative result and assumed investment rate provides a graphic illustration of the underlying cause of the unfunded liability of the System. In 1999 the System expected a return of \$2.20 for every dollar invested over the next 10-year period, but the actual result was a return of \$1.30 for every dollar invested.

Another measure of SBCERS' performance is its ranking compared to other public pension funds. The following chart shows a comparison as of December 31, 2008 with a universe of other public funds.^{12,13}



Tabular data provided in that same report showed that for the periods noted that SBCERS investment performance was ranked in the bottom 21 to 28 percent (72nd to 79th percentile) of the funds used in the survey.

¹² Universe Source: The Bank of New York Mellon Corporation

¹³ "Santa Barbara County Employees' Retirement System Investment Portfolio: Quarterly Report Executive Summary", December 31, 2008, Pension Consulting Alliance

The Actuarial Interest Rate

Given the difference between the expected return and the portfolio performance raises the question, is the actuarial interest rate too high? The Grand Jury's answer to this question is "yes". From the Public Funds Survey, the median rate of 125 public pension funds was 8.0%. The country's largest pension fund CalPERS, uses 7.75% for its general Public Employees Retirement Fund. Wilshire Consulting, one of the country's largest pension-consulting firms raises a significant point:

*Using Wilshire's return forecasts, only eight of the 106 cities and county retirement systems are expected to earn long-term asset returns that equal or exceeds their actuarial interest rate assumption.*¹⁴

Milliman, the System's actuary notes:

*There has been a recent trend, especially since 2004, for systems to take a less aggressive approach to their total expected investment returns. These systems have lowered their investment returns assumption, generally below 8.00%. These recent changes may not be reflected in the current surveys, as there is a lag. These recent downward adjustments are likely an indication of a reaction to the recent market fall, as well as lower expected returns on the systems' portfolios.*¹⁵

At this time, SBCERS assumes an expected return in the upper 25% of public pension funds, and in general it has performed in the bottom 25%.¹⁶

The choice of the expected investment return by public pension funds has recently become the subject of much debate. Historically public pension funds have used an actuarial-based investment return with time horizons on the order of 50 years or more. A variety of studies have raised misgivings about this approach with the recommendation that the actuarial interest rate be replaced by a more conservative measure such as the "risk free return" rate associated with Treasury bonds. This reduced rate of return would result in dramatically increased Normal Cost contribution rates by both the employer and employee, and would substantially increase the initial unfunded liability. The long time horizons associated with pension plans are based on the scenario that employees may begin employment in their 20's, retire in their 60's and live into their 90's. A problem arises, however, when as a result of poor performance relative to the system's stated

¹⁴ Wilshire Consulting, "2007 Wilshire Report on City & County Retirement Systems: Funding Levels and Asset Allocation", September 14, 2007

¹⁵ Milliman, "Investigation of Experience for the period July 1, 2003 to June 30, 2007", page 36

¹⁶ "Public Fund Survey", <http://www.publicfundsurvey.org>

goals within the much shorter time frame of the sponsor's interest, the sponsor's required payments exceeds its ability to pay. A more conservative approach, while requiring higher initial payments, reduces the probability that such a critical situation could arise. In both cases the benefits will be paid; the use of optimistic estimates that are not achieved merely moves the realization of the true costs into the future. Based on a review of other public pension fund performance and assumed investment returns, the Jury believes that the assumed actuarial interest rate of 8.16% is too high. In the previously referenced report Milliman concluded the actuarial interest rate could be as low as 7.5%. Both Milliman and Wilshire Consulting referenced material were written before the October 2008 market decline and resulting market uncertainties. The Jury believes that the use of an interest rate between seven to seven and three-quarters percent would be more realistic than the current 8.16%.

Asset Allocation

A major factor in the investment return of any pension fund is asset allocation, allocating its investment portfolio among a variety of investment possibilities. For example a portfolio could be invested in various areas: U.S. stocks and foreign stocks, bonds and emerging market stocks. Pension funds, because of their size, have a number of alternative investment choices: private equity placements, hedge funds, options, derivatives, real estate, commodities, etc. Each of these alternative investment areas has its set of risks and rewards. Studies have shown that asset allocation is a greater factor in influencing investment results than the choice of individual investments within a particular sector.¹⁷ The Retirement Board has conducted an Asset-Liability Review examining such alternative investments. Recent market events emphasize the need for detailed understanding and transparency of these alternative investment approaches. Participating in these alternative investments requires a high degree of due diligence and continuing in-house oversight. Recently SBCERS has established a financial analyst position that adds to its capability of analyzing and tracking investment performance of these alternative investment approaches.

How the SBCERS Retirement Board Functions

Although the choices of actuarial interest rate and asset allocation are important, the critical factor is long-term growth of the system assets with acceptable risk. The responsibility for this rests with the members of the Board. Given the important role of the Board, it is worthwhile to look at its composition, member's background and professional support.

¹⁷ See for example, Ibbotson, Roger G., and Paul Kaplan, 2000, "Does Asset Allocation Policy Explain 40, 90, or 100% of Performance?", *Financial Analyst's Journal* 56, No. 1 (January-February): pages 26-33.

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The Board is not a group of investment professionals. It provides oversight, establishes goals, reviews investment results and provides guidance to the administrator. Board members have no required formal qualifications in terms of job-related experience or education. This concerns the Board of Supervisors who is formulating guidelines for members they appoint. Board members are offered training at Stanford or Wharton School of Business, and the State Association of Retirement Systems (SACRS). While not all members of the Board have participated in such training, most of the Board have attended one of these programs.

The Board allocates the assets of the portfolio among different investment management firms, using the services of an investment adviser. The role of the investment adviser, Pension Consulting Alliance (PCA), is significantly different from that of a personal financial planner for an individual investor. PCA provides initial screening for investment managers, analyzes options regarding asset allocations and analyzes different investment options. PCA also monitors portfolio performance and the investment managers' performances versus benchmarks. These investment managers provide the day-to-day management of the portfolio. The investment manager's performance is measured against a passive benchmark suggested by PCA. The benchmark is chosen to reflect the market performance of an unmanaged group of either equity or fixed-income investments within that investment managers' sector of the investment portfolio. An example of such a benchmark is the Standard and Poor's 500 stock index. PCA provides a detailed performance report of each investment manager. Managers whose performance fall below the defined goals related to the benchmarks over a period of time are placed on a probationary status. While there are criteria for investment managers to be placed on a probationary status, there appear to be no set criteria for terminating their management. The Board is responsible for replacing underperforming managers. The issue is not simple, but it is important.

At SBCERS there is a gap between the roles of the members of the Board and the investment managers and advisers which could be bridged with significant in-house investment expertise. The role of the in-house support would be to provide increased scrutiny of the investment performance of current managers and to provide more definitive recommendations regarding investment decisions to the Board. Even with the market losses, SBCERS investment portfolio is over one billion dollars, and the need for strong professional investment guidance is apparent. Market events of the last six months also emphasize the need for additional investment review and examination. Neither domestic nor international market events of the last year are falling within the paradigm used by investment managers in the recent past. Diversification and asset allocation strategies are all being reviewed. It is unrealistic to expect the Board members to be experts in these areas. As was noted earlier, establishing a financial analyst position is a step in the right direction.

The Retirement Board defines the role of the administrator of the System. The current administrator is employed on a temporary basis. The Board is searching for a permanent replacement. The previous administrator possessed an extensive background in pension

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fund administration, and the Jury believes, left a competent, professional staff. Given the current investment environment, the past investment history of the system, and with the appreciation that the Board members are generally not financial professionals, the Jury believes that it would be highly desirable for the new administrator to bring significant investment knowledge and leadership as well as administrative experience to the System. The interim administrator has been active in discussing investment approaches, and the Jury hopes that this continues with the new administrator.

Board meetings are generally scheduled once a month. The scope of these meetings is broad, with discussion of disability issues, administrative matters, as well as investment related topics. Discussions of investment strategies, results, and actuarial calculations can be confusing, and it appeared that there was a "re-learning" period during each meeting. As a result Board meetings last too long for members of the Board to retain information. Alternatives to the current approach need to be studied, such as greater use of specialized sub-committees, which could be delegated to review and recommend actions in their specific areas and/or more frequent meetings.

CalPERS

The preceding material deals with issues associated with the current structure of the SBCERS. The other 19 counties whose systems were enabled under the 1937 Retirement Act have a structure essentially identical to that of Santa Barbara County. How do the other 38 counties in California manage their retirement systems? In 36 of them the answer is CalPERS.

The California Public Employees' Retirement System (CalPERS) manages pension and health benefits for more than 1.6 million California public employees, retirees, and their families. It is the largest public employees' pension fund in the country. Its investment return over the 10-year period ending June 30, 2008 was 6.5%.¹⁸ It functions, as does SBCERS, as an administrator of defined benefit pension systems. CalPERS has received considerable publicity recently, and has incurred significant asset losses from leveraged real estate investments. In some cases these assets losses may exceed the original investment. CalPERS has not been immune to the impact of the recent market downturn. For example, it showed asset losses of \$73 billion in the period June 30, 2008 - March 9, 2009, a 31% decline. The impact of revaluing the leveraged real estate investments may not be complete. Many of the executive management of CalPERS having been recently selected, and as the problems with the real estate portfolio are still not clear, the wisdom of moving to CalPERS at this time is questionable. CalPERS' investment returns over a longer period are excellent and movement of the Retirement System is a future option.

¹⁸ "CalPERS Comprehensive Annual Financial Report, Year Ended June 30, 2008", page 87. For the comparable period SBCERS investment return was 5.7%.

Pension and Other Post-Employment Benefits (OPEB)

While the stress on SBCERS may be largely attributable to the performance of the investment portfolio, another significant factor has been the cost of benefits. Santa Barbara County followed a tendency of many other California counties in granting increased benefits at times when the systems were well funded and the systems performance was strong. The rationale was in part that the future market gains would pay for the cost of the increased benefits. With the optimistic market return assumptions, the cost of new benefits seemed modest. However, when the performance of SBCERS declined below expectations, it made it more difficult for the County to fund the benefits. Public pension benefits for almost all systems in California followed a strikingly similar pattern in the last 10 years. Decisions were made which ignored the fundamental unpredictability of the market and the potential impact of future obligations. The lesson hopefully learned is that every benefit increase has a cost.

In addition to a cost-of-living adjustment (COLA) retirees also receive a health care subsidy. The County established a 401(h) health savings plan in which these benefits are provided on a tax-free basis. The current County contribution rate for this plan is 3% of the enrolled payroll, which must be added to the retirement system contribution to show the total employer retirement contribution. All County employees except safety members also participate in Social Security, for which the employer contributes 6.2% of the employees' salary.

The Board of Supervisors decides pension benefits generally in closed sessions, with their adoption in the public session. The Retirement Law of 1937 requires that benefit increases be supported by an actuarial report. This report of the future annual costs must be presented at a public meeting at least two weeks prior to the adoption of any increases in benefits. The last significant benefit increase included an actuarial statement showing the changes in the County's contribution rate. There were no explanations of the costs in terms that the public could reasonably be expected to understand.

In a report prepared by The Public Employee Post-Employment Benefits Commission Recommendation 13 of the report¹⁹ states:

With the exception of school districts and County offices of education, legislation should be enacted to amend Government Code Section 7507 to require that pension and/or OPEB benefit changes be subject to the public notice requirements found in that section and be presented with an actuary available to answer questions or to provide additional information, as needed. The presentation and report should be in language easily understood by the

¹⁹ See footnote 3

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layperson, and such information should not be placed on the consent calendar.

Future Options

As noted earlier, the severe market decline will have a significant impact on the County budget beginning in 2010. However, the County has a number of options:

1. The County's payment of the unfunded liability is currently amortized over a 15-year period. This amortization can be increased to 30 years, which would result in a reduction of approximately \$10 million in the contribution in fiscal year 2010. The cost of a longer amortization is similar to refinancing a mortgage. Lower monthly payments being paid over a longer period of time results in a higher total cost.
2. Issuing a Pension Obligation Bond (POB) is an option that has been used by other California counties. The cost of POBs is paid out of a county's general fund and the proceeds are used to eliminate or reduce the unfunded liability. The rationale for issuing these bonds is that the County can borrow money at a relatively low interest rate, under the assumption that the money will grow at a higher interest rate. Examining some counties that have used POBs leads to the following observations. In cases where there were one-time issues associated with a change in the unfunded liability, such as actuarial changes, lawsuit settlements, etc., POBs seem to have been useful. In other cases where the unfunded liability growth was due to other continuing factors, the counties often needed to issue more than one POB. In short, it appears that POBs have worked out well in addressing extraordinary situations, but provided only a "patch" on systems that had more serious basic issues.
3. Unless the Retirement System's investment performance improves, or there are significant revenue increases, major changes in the System will be required to avoid service cutbacks and employee layoffs in the future. Changes in compensation, benefit structure, and quantifiable improvements in efficiency are among the possible options. Many alternatives require negotiations with the employee unions. In some cases it may require amending the 1937 Act. In the current economic climate it is critical that both the County and employee unions find accommodations that are equitable for County employees and affordable to the County.
4. A specific option that has been proposed is to change the pension plan from a defined benefit to a defined contribution plan. The immediate drawback is that it could require a change in the state law. Since it would not affect current members of the defined benefit system it would do nothing to alleviate the unfunded liability. Obviously if such a plan were to be offered to new employees, the issue of future benefit costs would not be a factor since the employer has no post-employment obligations in such a plan. There are, however, a number of factors, financial and otherwise, that enter into consideration. The results of a recent research paper comparing defined contribution and defined benefit plans had the following conclusion "...the bottom line is that a DC (Defined

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Contribution) plan requires a great deal *more* money to be set aside than a DB (Defined Benefit) plan for a comparable lifetime retirement income, yet in practice it collects much *less* money in contributions and earnings.”²⁰ This is not meant to dismiss the need for structural changes in the pension system. In fact, there is a considerable amount of research regarding this issue at such places as the Center for Pension Research at the Wharton School of the University of Pennsylvania, and the Center for Retirement Research at Boston College.

5. Moving the System to CalPERS. The costs and length of time for a transition would have to be considered. The local support to members of the system would have to be addressed. While the current unfunded liability would be restated to reflect CalPERS actuarial assumptions, it would not, in itself, obviate the need for large increases in the County contribution.

A Need for Change

The impact of the Retirement System's investment losses on the County's budget is significant, and requires urgent attention. The fact that many other cities and counties find themselves in similar situations does not mitigate the need for actions to address this issue. The recession has increased County public service needs, while County revenue sources in many cases are decreasing and pension obligations will be significantly increasing. The Grand Jury believes that the severity of these issues and the consequences of inaction are understood by the Board of Supervisors and the Retirement Board. Translating that understanding into both short and long-term actions is likely to be both challenging and painful. While there is also a need to address long-term issues the findings and recommendations that follow emphasize short-term actions.

FINDINGS AND RECOMMENDATIONS

Finding 1

While in the recent past, according to accepted actuarial practices, the Santa Barbara County Employees' Retirement System was adequately funded, recent market losses will have a significant negative impact on the funding level of the Retirement System.

Finding 2

The investment performance of the Santa Barbara County Employees' Retirement System in general has ranked in or near the bottom quartile of the Bank of New York

²⁰ Waring, "Between Scylla and Charybdis, Improving the Cost Effectiveness of Public Pension Retirement Plans", Pension Research Council Working Paper, Pension Research Center, The Wharton School, University of Pennsylvania October, 2008

SANTA BARBARA COUNTY EMPLOYEES' RETIREMENT SYSTEM

Mellon Corporation universe of public pension funds during the one - three - five year periods ending December 31, 2008.

Recommendation 2a

That the Retirement Board improve its in-house investment analysis capability, and consider establishing the position of Chief Investment Officer.

Recommendation 2b

That the Retirement Board adopt stated criteria for the termination of underperforming investment managers.

Finding 3

During Board meetings, considerable time is spent recalling what happened at the previous meeting.

Recommendation 3

That the Board meet more than once a month or establish specialized sub-committees.

Finding 4

The use of an actuarial interest rate of 8.16% is overly optimistic, has understated the estimated payments required to fund retirement benefits, and has therefore contributed to the growth in the unfunded liability.

Recommendation 4

That the Retirement Board adopt an actuarial interest rate between seven and seven and three-quarters percent.

Finding 5

Increased pension obligations will be a significant County budget problem in the near future. Accounting changes are required to provide temporary relief from the near term impacts of recent market events.

Recommendation 5

That the Retirement Board institute a temporary increase in the unfunded liability amortization period to 30 years, returning to a 15-year amortization after a period of between 10 to 15 years.

Finding 6

The cost of benefit increases are insufficiently explained to the general public

Recommendation 6

That the Board of Supervisors adopt, as a policy, the pertinent parts of Recommendation 13 of The Public Employee Post-Employment Benefits Commission report "*Funding Pensions & Retiree Health Care for Public Employees*". Specifically, any material provided should be presented in a manner that is easily understood by the public.

REQUEST FOR RESPONSE

In accordance with *California Penal Code Section 933.05* each agency and government body affected by or named in this report is requested to respond in writing to the findings and recommendations in a timely manner. The following are the affected agencies for this report, with the mandated response period for each.

Santa Barbara County Employees' Retirements System - 60 Days

Findings 1, 2, 3, 4, 5
Recommendations 2a, 2b, 3, 4, 5

Santa Barbara County Board of Supervisors - 90 Days

Finding 6
Recommendation 6