BOARD OF SUPERVISORS AGENDA LETTER

Clerk of the Board of Supervisors
105 E. Anapamu Street, Suite 407
Santa Barbara, CA 93101
(805) 568-2240

Agenda Number:

Department Name:	Human Resources
Department No.:	064
For Agenda Of:	11/7/2006
Placement:	Departmental
Estimate Time:	2 PM - 2 hours
Continued Item:	NO
If Yes, date from:	
Vote Required:	Majority

TO: Board of Supervisors

FROM: Department Director(s) Michael F. Brown, CEO
Robert W. Geis, Auditor-Controller
Contact Info: Susan Paul, Asst. CEO/HR Director 568-2817

SUBJECT: **Kroll and Mercer Human Resources Consulting Report Concerning the Evaluation of the Santa Barbara County Employees Retirement System (SBCERS)**

County Counsel Concurrence:
As to form: ☐ Yes ☐ No ☐ N/A

Auditor-Controller Concurrence:
As to form: ☐ Yes ☐ No ☐ N/A

Other Concurrence: N/A
As to form: ☐ Yes ☐ No ☐ N/A

Recommended Action(s):

1) Receive and file the Kroll and Mercer Human Resources Consulting Report concerning the evaluation of the Santa Barbara County Employee Retirement System (SBCERS).

2) Direct the County Executive Officer (CEO) and Auditor-Controller to work with the SBCERS to achieve the objectives outlined in this report and the attached action plan.

3) Return to the Board in 120 days for a progress update regarding the achievement of stated objectives.

Summary:

Earlier this year, the Board directed the County Executive Officer (CEO) and the Auditor-Controller to conduct a review of the Santa Barbara County Employees Retirement System (SBCERS), its financial status, and the impact of post-employment benefits, including Retiree medical benefits. More specifically, the Board was interested in obtaining and reviewing information regarding the following key items:

- The methodology used to determine current rates for normal costs and UAAL (unfunded liability).
- Whether the system is under-funded, over-funded, or properly funded.
- An evaluation of the calculation of "Excess Earnings" as described in the County 1937 Act Retirement Law.
- An evaluation of the methodology and actuarial assumptions used by the SBCERS actuary in determining the actuarial accrued liability.

- An evaluation of other benefits that the Board of Retirement currently grants to retirees or may grant to employees with Board of Supervisors approval.

- Retiree Health Benefits.

Background:

To accomplish the outlined assessment and review, the CEO and Auditor-Controller contracted with Kroll and Mercer Human Resources Consulting. The work on this project began in approximately June 2006 and was completed in September. The consultants reviewed multi-year SBCERS Annual Financial Reports and actuary reports, the health benefit allowance history, the 1937 Act Retirement Law, and Government Accounting Standards Board (GASB) 43/45 materials. In addition, the consultants reviewed the distribution of "Excess Earnings," the legal opinion/analysis of the use of SBCERS Excess Earnings used to provide retiree health benefit changes and SBCERS Reserve analysis materials. Finally, the consultants interviewed and coordinated with the retirement system, its actuary, and other key stakeholders.

The results of the Kroll and Mercer review are contained in the attached report. In general, the review concluded that at present, SBCERS is being funded in a reasonably sound manner. However, the consultants also identified that some of the standard practices and policies of SBCERS and the County could jeopardize the funded status of the system in the future. Additionally, the consultants identified significant concerns related to the transparency and misunderstandings of the underlying dynamics of SBCERS. This is particularly true as to the effects of decisions related to additional benefits granted either through the deposition of Excess Earnings or through the Board of Supervisors. In order to resolve these critical issues and maintain the soundness of SBCERS, the consultants recommended focusing on the following:

- Developing transparency so that decision makers and stakeholders can better understand what is happening in the system at any given point in time.

- Improving technical compliance.

- Analyzing specific system dynamics in order to develop more appropriate polices to guide decisions related to SBCERS.

- Developing more appropriate policies related to SBCERS. In particular, technical compliance with the retiree healthcare payments, the policy for using Excess Earnings, and the basis on which benefit improvements have been made.

These recommendations are aimed at improving the consultant's key findings which are outlined below:

- The mechanism for paying retiree healthcare benefits does not appear to be consistent with federal law, potentially jeopardizing the tax qualification of SBCERS and tax returns for all retirees receiving healthcare benefits.

- The number of different reserve accounts established by SBCERS and the discretionary transactions between those reserve accounts make the system less transparent than it should be.

- The SBCERS policy for using Excess Earnings appears to be independent of fiduciary responsibilities for protection pension benefits and creates an asymmetrical risk distribution for the County.

- The analysis used to grant benefit improvements failed to test the sensitivity of assumptions and may have underestimated the cost of those benefit improvements.

- The practice of establishing reserves as both assets and liabilities under GASB 25 distorts the reported funded status and makes benefit improvements appear less costly than they really are.

- The practice of crediting reserves with the assumed rate of earnings each year instead of the actual rate of earnings distorts funding levels, is not transparent, and may prevent the recognition of those assets for purposes of GASB 43 and 45.

- When actuarial assumptions are next reviewed, particular attention should be paid to certain factors including mortality, the number of public safety retirements, inflation and wage growth, and final year compensation measures.

- SBCERS appears to view benefits that are fully funded through Excess Earnings as creating no additional cost to the County. Any benefit improvement has a cost and does impact County cost.

The CEO and the Auditor-Controller recommend that the County work with the SBCERS to take appropriate action to correct identified areas of needed improvement, investigate alternatives, and develop appropriate policies. The objectives of working with SBCERS on these issues are as follows:

- Confirm compliance with applicable laws and regulations.

- Improve the stability of the retirement system.

- Improve the transparency of the retirement system.

- Review the proposal to establish a 401(h) account which appears to vest benefits that are not currently vested and may contravene Section 401(a).

- Determine if there may be an implicit retiree healthcare subsidy that should be valued under GASB 45.

Lastly, it is recommended that the CEO and Auditor-Controller return to the Board in approximately 120 days with an update on working with SBCERS and the progress made toward achieving the stated objectives.

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Fiscal and Facilities Impacts:

Budgeted: ☐ Yes ☐ No

Fiscal Analysis:

Funding Sources	Current FY Cost:	Annualized On-going Cost:	Total One-Time Project Cost
General Fund			
State			
Federal			
Fees			
Other:			
Total	$ -	$ -	$ -

Narrative:

Staffing Impact(s):

Legal Positions: **FTEs:**

Special Instructions:

Attachments:

Kroll and Mercer Human Resources Consulting Report
Action Plan

CC: Shane Stark, County Counsel
Susan Paul, Assistant CEO/ HR Director
Betsy Schaffer, Chief Deputy Controller, Auditor-Controller's Office

November 7, 2006

Retirement System Evaluation

County of Santa Barbara

Retirement System Evaluation County of Santa Barbara

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Mercer Human Resource Consulting i g:\wp\retire\2006\cnys01\santa barbara report final.doc 111 SW Columbia Avenue, Suite 500 Portland, OR 97201-3693 503 273 5920 Fax 503 273 5999 bill.hallmark@mercer.com www.mercerHR.com Mercer Human Resource Consulting g:\wp\retire\2006\cnys01\santa barbara report final.doc Mr. Robert W. Geis, CPA Auditor-Controller County of Santa Barbara 105 E Anapamu Street, Room 303 PO Box 39 Santa Barbara, CA 93102-0039 Dear Bob: We conducted a high-level evaluation of the Santa Barbara County Employees Retirement System (SBCERS) based on documents provided by the County and SBCERS. We conclude that at present SBCERS is being funded in a reasonably sound manner, but that some of the standard practices and policies of SBCERS and the County could jeopardize the funded status in the future. In particular, the lack of transparency in the system makes it difficult for decision makers and other stakeholders to understand what is happening to the system at any point in time. While some concerns relate to issues of technical compliance, there are significant concerns related to the lack of transparency and misunderstandings of the underlying dynamics of SBCERS, particularly as it affects decisions related to additional benefits granted either through the disposition of Excess Earnings or through the Board of Supervisors. Our recommendations focus on correcting issues of technical compliance, improving the transparency of SBCERS and developing analysis of specific system dynamics in order to develop more appropriate policies to guide decisions related to SBCERS. In particular, we are concerned about the technical compliance of the retiree healthcare payments, the policy for using Excess Earnings, and the basis on which benefit improvements have been made. All of these issues would benefit from some simplification of the reserves used and changes to the financial reporting of the system. We appreciate the opportunity to work with the County of Santa Barbara, and we are available to answer any questions you may have about the report. Sincerely, William R. Hallmark, ASA, EA, MAAA Troy Dahlberg Principal Managing Director Mercer Human Resource Consulting Kroll WorldwideRetirement System Evaluation County of Santa Barbara

Retirement Plan Financial Management

In order to illustrate and clarify the effect different policy decisions have on achieving the objectives of a retirement system, we use our Retirement System Financial Management Framework. The essence of the framework, illustrated below, is that the System's objectives are controlled by three primary policy areas: Benefits Policy, Investment Policy, and Funding Policy. These three policies are coordinated through the System's governance structure, and the interaction of these policies and the external environment determine the costs of the System and the benefits provided by the System.

Benefits Policy

Ultimately, the costs of a retirement system are determined by the benefits paid to the members of the system less any investment earnings. The benefits of SBCERS are primarily set by the County's Board of Supervisors by resolution. However, the Retirement Board also grants some benefits through the use of "Excess Earnings."

The benefits policy includes:

- Eligibility and vesting provisions,
- Benefit amount provisions, and
- Optional forms.

Investment Policy

The investment policy for SBCERS is the responsibility of the Retirement Board. Their decisions regarding the allocation of assets have a tremendous impact on the cost, benefits and stability of SBCERS. The ultimate cost of a retirement system equals the benefits paid out less any investment earnings. Generally, if greater investment earnings are achieved, the cost of the benefits is reduced, and if investment earnings are lower than expected, the cost of the benefits is increased. However, with SBCERS current policy on the use of "Excess Earnings," some of the higher investment earnings are used to increase benefits instead of reducing costs. The investment policy also determines the likelihood of "Excess Earnings."

Funding Policy

The funding policy includes all of the assumptions and methods used to set contribution rates for the members and the County. This policy is the responsibility of the Retirement Board. For the most part, these decisions determine the pattern of contributions over time and the division of costs between the Members and the County, but do not affect the ultimate cost in the way that the benefits policy and the investment policy do. The funding policy also determines how key indicators such as funded status and normal cost are calculated.

Governance

The mechanisms for coordinating these different policies are defined by the governance structure. For the County, the governance structure is largely defined by the division of responsibilities between the Board of Supervisors and the Retirement Board. In theory, the Board of Supervisors is solely responsible for the benefits policy and the Board of Retirement is responsible for the funding and investment policies.

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Funding Policy

As noted above, the funding policy is the responsibility of the Retirement Board, and largely determines the timing of contributions to the retirement system. It also affects the allocation of costs between members and the County. It is not intended that the funding policy affect the benefits paid, but under the current structure it may have an impact.

Theoretical Overview

Before discussing some of the issues specific to SBCERS, a basic theoretical overview is needed to illustrate how the funding policy is intended to work.
The value of retirement benefits does not accrue evenly over an employee's career. The nearer an employee is to retirement, the more valuable each dollar of annuity benefit becomes. The chart below shows that the value of the benefit (PVAB) for an employee hired at age 35 accumulates very slowly at first, but as the employee approaches retirement age the value accumulates quickly.
There are two primary reasons for this pattern. First, the value of the benefit today depends on how far in the future it is being paid. The plan discounts liabilities using an interest rate of 8.16%, so a benefit payment made today is 8.16% more costly than a benefit payment made a year from today.
The second reason is that the benefit formula is based on final average pay multiplied by years of service. Each pay increase received late in a member's career is multiplied by all of their prior years of service creating significant leverage for long service employees.
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Actuarial cost methods are designed to budget contributions so that the plan will have accumulated all of the assets needed to pay a member's benefit during his or her active years of service. However, because the value of the benefit accumulates so quickly at the end of an employee's career, actuarial cost methods budget higher contributions early in an employee's career to mitigate the needed increase late in their career. The Entry Age Normal cost method used by SBCERS attempts to allocate costs as a level percentage of pay over the employee's career. This accumulation pattern is shown in the chart above.
Actuarial cost methods define the increase in benefit attributable to an additional year of service as the normal cost. The chart to the right shows that the normal cost using the Entry Age method remains a level percentage of pay over an employee's career while the cost of the benefit actually accrued increases dramatically as the employee approaches retirement.

The Entry Age cost method calculates both the normal cost and the accrued liability for each individual member in the system. The sum of the individual normal cost and accrued liability is the liability for the plan.

The normal cost for the system as a percentage of payroll represents the theoretical long-term cost of the system. That is, if the normal cost were contributed every year from the beginning and all actuarial assumptions were met, no other contributions would be needed and no additional assets would remain when all benefits were paid.

The accrued liability represents the amount of assets the system should have at any given time in order to pay for the benefits attributable to prior service. It is equivalent to the accumulation of the normal costs from the beginning adjusted for interest and benefit payments.

In determining contribution rates, the accrued liability is compared to assets and the difference (the unfunded accrued liability) is amortized, in SBCERS case, over 15 years as a level percentage of expected payroll. The chart below shows that this amortization payment is added to the normal cost to determine the total contribution rate.

In an effort to smooth out some volatility in contribution rates, the assets that are compared to the accrued liability are not the fair market value of assets, but an actuarial value that smoothes out variations in investment performance over a period of 5 years. Without this smoothing, contribution rates could swing significantly from one year to the next depending on the prior year's investment return.

For SBCERS, the total normal cost is divided between a portion paid by the County and a portion paid by members.

Each year, the accrued liability is expected to grow by the normal cost plus interest, less any benefit payments. Assets are expected to grow with contributions and earnings, less benefit payments.

Projections for SBCERS

One of the questions raised for our evaluation was whether or not the system would pay off its UAL even if all assumptions were met. The following chart shows the growth in the accrued liability and the actuarial value of assets if all assumptions are met each and every year. After about 20 years, the assets and liabilities are identical.

However, as shown in the chart below, the UAAL is actually projected to get larger initially before declining. It eventually declines to below zero before returning to zero. Both of these apparent anomalies are due to the asset smoothing method. The asset smoothing method has deferred recognition of some gains and losses to the future so they are not included in the current amortization payment. When the losses are recognized, the UAAL increases and these losses are amortized over 15 years. When the asset gains from investment performance the last couple of years are recognized, they are also amortized over 15 years and are the cause of the projected negative UAAL after all other gains and losses have been paid.

From a basic fundamental level, the actuarial methods do what they are supposed to do, and if the system earns 8.16% interest every year, the UAAL will be paid off and the plan will become fully funded.

Actuarial Methods and Assumptions

Our review is not intended to be an actuarial audit of the methods and assumptions employed by the actuary, but we will offer a few comments and suggestions for consideration and additional research.

Actuarial Cost Method

The system uses the entry age normal cost method. This method is used by the vast majority of public systems and is an excellent method for a final average pay plan such as SBCERS. It spreads the cost of benefits as a level percentage of pay over a member's career. We concur with the selection of this method.

Asset Smoothing

The actuarial value of assets is a smoothed market value in which unexpected investment returns are recognized over a 5-year period. The purpose of using such a method is to smooth out the impact of volatile investment returns on contribution rates. The method employed is a common method and is unbiased. That is, it doesn't systematically under or over value assets.
The smoothing method employed is effective at smoothing contribution rates due to short-term volatility. The only concern we have with this method is transparency and potential misuse of the actuarial value of assets. For example, because assets are being smoothed, the System may find itself raising contribution rates right after a year of great investment performance or reducing contribution rates right after a year of very poor investment performance relative to the assumed rate of return. Similarly, in using the actuarial value of assets to report funded status (as required by GASB), decision makers and stakeholders can be misled as to the true funded status which may be higher or lower than the reported funded status. As we will note in our discussion of benefit improvements, if decisions are made without reference to the funded status on a market value (not actuarial value) basis, decision makers may be led to the wrong decision.

Amortization Method

The UAAL is currently amortized as a level percentage of payroll over a period of 15 years. Using a level percentage of payroll approach means that amortization payments start low and are expected to increase over the amortization period. In using this approach, we think it is important to make sure the first year's amortization payment will at least cover the interest on the UAAL. Otherwise, the UAAL will be expected to increase. SBCERS uses a 15 year amortization period, and the amortization payment exceeds interest on the UAAL. It should be noted that the longer the amortization period, the more stable contribution rates will be, and the shorter the amortization period, the more volatile contribution rates will be.

Retiree Mortality

Since actuarial valuations make projections many years into the future, and the value of benefits depends heavily on the length of time those benefits are expected to be paid, actuaries should anticipate some level of mortality improvement in making retiree mortality assumptions. There are two general approaches that are used: the common approach of a static mortality table projected to reflect anticipated mortality rates, or a generational mortality table with anticipated improvements built into the table.
SBCERS uses the static mortality table approach, but does not appear to have anticipated future mortality improvement. In the last experience study, mortality rates were set such that they would accurately predict the number of deaths in the short run by targeting an actual death to expected death ratio of 100%. To anticipate future mortality improvements, mortality rates should be set to target a higher actual to expected ratio.

Inflation and Wage Growth

The inflation assumption is consistent with the assumption used by many other '37 Act counties, but is higher than most historical periods and higher than the current market consensus expectation as represented by the difference between the yields on nominal Treasury securities and Treasury Inflation Protection Securities.
While the inflation assumption is high compared to Mercer's standards, it is also used as a wage growth assumption. The wage growth assumption represents the average expected increase in pay other than for merit or longevity. Normally, we expect the wage growth assumption to be 75 to 150 basis points higher than the inflation assumption.

Reserve Accounts

The dynamics of the system, however, get a bit more complex when the various reserve accounts are taken into account. We have summarized the reserve accounts as of June 30, 2005, below.

Types of Reserves	Value at 6/30/2005	Trend over period	Sources of Growth	Sources of Decline	Interest Credit	Underlying Benefit
Member Reserves	$135m	Growing	Contributions, interest	Member refunds; transfers for new retirees	8.16%	Member accounts for current and former employees not yet retired
County & District Reserves	$487m	Growing	Contributions, interest, transfers from other reserves (e.g. Strategic Reserve, Benefit Enhancement Reserve)	Benefit payments; transfers for new retirees; initial setup of APCD	8.16%	Employer accounts for current and former employees not yet retired
Strategic Reserve	0	Fully Distributed	Interest; transfers from Stability Reserve (excess earnings)	Transfers to other reserves	8.16%	No underlying benefit
Benefit Enhancement Reserve	0	Fully Distributed	Interest; transfers from Stability Reserve (excess earnings)	Transfers to other reserves	8.16%	Available to increase the benefits underlying other reserves

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Retired Member Reserves	$679m	Growing	Transfers for new retirees, interest, transfers for benefit enhancements (purchasing power)	Benefit payments, transfers to other reserves	8.16%	Supports benefits in payment status (annuities)
Burial Allowance Reserve	$5m	Growing	Interest; transfer for benefit increase (from excess earnings)	Benefit payments	8.16%	Death benefit
Health Coverage Reserve	$45m	Growing	Interest, transfer from Contingency Reserve	Benefit payments	8.16%	Retiree health benefits
Supplemental Health Coverage Reserve	$48m	Growing	Interest, transfer from Strategic Reserve (and small amount from Contingency Reserve)	Benefit payments	8.16%	Retiree health benefits
Sick Leave Reserve	$5m	Growing	Interest	None	8.16%	Short term disability
Spousal Continuance Reserve	$2m	Growing	Interest	None	8.16%	Special postretirement benefits for surviving spouses
Special Allowance Reserve	$20m	Declining	Interest	Benefit payments	8.16%	Purchasing power COLA
APCD Death Allowance Reserve	$39k	Growing	Interest, transfers from District & County Reserve	None	8.16%	Death benefit

Contingency Reserve (<> 1-3% of NAV)	$25m	Variable	Interest, transfers from excess earnings	Transfers to excess earnings and to health reserves	8.16% in some years	No underlying benefit

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Market Stabilization Reserve	$45m	Variable	Excess earnings (negative in some years); transfers from Contingency Reserve	Transfers to other reserves	Variable	No underlying benefit

The sheer number of reserve accounts makes it difficult to keep track of what reserves are used for what purpose.

Reporting Reserve Accounts Under GASB 25

All reserve accounts are included in the actuarial value of assets for GASB 25 reporting purposes, but the Health Coverage Reserve, the Supplemental Health Coverage Reserve, the Special Allowance Reserve and the Contingency Reserve are also included in the Actuarial Accrued Liability for GASB 25 reporting purposes.
Paragraph 36a of GASB 25 defines the benefits that are to be included in the disclosed liability as "all pension benefits to be provided by the plan to plan members or their beneficiaries in accordance with (1) the terms of the plan and (2) any additional statutory or contractual agreement(s) to provide pension benefits through the plan that are in force at the actuarial valuation date." GASB 25 specifically excludes assets and liabilities related to retiree healthcare benefits. Consequently, the assets and liabilities related to the healthcare reserves should be excluded from GASB 25 reporting, and the Special Allowance and Contingency Reserves should be reported as assets, but not liabilities.
The actuarial value of assets smoothes unexpected investment returns on market value over five years. The smoothing calculation is performed on total assets, but the non-pension reserves are excluded from pension calculations at market value instead of their smoothed value. Given the relatively small size of the non-pension reserves, the impact of this inconsistent treatment is minimal at this time.

Reserve Account Transactions

With all of the different reserve accounts, serving different purposes, it is important to understand how and when funds move from one reserve to another. We identified the following types of transactions.

Contributions

Contributions are made to the Member Reserve and County & District Reserve. No other reserves receive contributions.

Benefit Payments

Payments for various types of benefits are made from the Retired Member Reserve, the County & District Reserve, the Burial Allowance Reserve, Health Coverage Reserve,

Supplemental Health Coverage Reserve, and Special Allowance Reserve. In addition, member refunds are paid from the Member Reserve.

Upon Retirement

When a member retires, assets are transferred from the Member Reserve and the County & District Reserve to the Retired Member Reserve.

Interest Crediting

A guaranteed rate of 8.16% is credited each year to the following reserve accounts:

- Member Reserves,
- County & District Reserves,
- Strategic Reserve,
- Benefit Enhancement Reserve,
- Retired Member Reserves,
- Burial Allowance Reserve,
- Health Coverage Reserve,
- Supplemental Health Coverage Reserve,
- Sick Leave Reserve,
- Special Continuance Reserve,
- Special Allowance Reserve, and
- APCD Death Allowance Reserve.

In 2003 and 2004, but not other years, interest was also credited at 8.16% to the Contingency Reserve. Any remaining earnings or any shortfall in earnings is credited or charged to the Market Stabilization Reserve.

Expenses

Administrative and investment expenses are charged to the Market Stabilization Reserve.

Transfers to/from Contingency Reserve

In 2004, $11.5m was transferred from the Contingency Reserve to the health reserves. Otherwise, all transfers to or from the Contingency Reserve were from or to the Market Stabilization Reserve – apart from interest crediting. The Contingency Reserve was just above 3% of MVA at June 30, 1999 and received a transfer to keep it at 3% at June 30, 2000. The entire reserve was transferred out, but then transferred back

at exactly 3% of MVA the following year. Since then the account has just grown with interest apart from the transfer to the health accounts. Interest crediting ceased after June 30, 2004.

Transfers from the Strategic Reserve

The Strategic Reserve was fully distributed over the period (from a starting point of $22m). Over a two year period, the assets were transferred to the County & District Reserve, Retired Member Reserves, Supplemental Health Coverage Reserve, and Stability Reserve – with the latter receiving more than half.

Transfers from the Benefit Enhancement Reserve

The Benefit Enhancements Reserve was fully distributed over the period (from a starting point of $22m). Over a two year period, the assets were transferred to the County & District Reserve for an unfunded liability and then for a benefit enhancement.

Transfers for Unfunded Liability

In 1999 and 2000 the County & District Reserves received transfers for unfunded liability. These transfers came from Retired Members Reserve, Benefit Enhancement Reserve and Strategic Reserve.
By crediting the assumed rate of interest to most reserves, there is an implicit transfer to or from these reserves when earnings aren't identical to 8.16%. Other transfers raise questions as to the purpose of the transfer, particularly when the opposite transfer is made a few years later.

Excess Earnings

The County Employees Retirement Law of 1937 ('37 Act) defines Excess Earnings and how those Excess Earnings can be used by retirement systems subject to the '37 Act. According to the '37 Act, earnings in excess of the assumed rate credited to all reserves are generally to "remain in the fund as a reserve against deficiencies in interest earnings in other years, losses on investment and other contingencies…." However, the '37 Act permits the disposition of Excess Earnings for certain purposes such as retiree healthcare benefits when Excess Earnings exceed 1% of the total assets of the retirement system. It should be noted that the '37 Act restricts the disposition.

> Where the Board of Supervisors has provided for the payment of all, or a portion, of the premium, dues, or other charges for health benefits, Medicare, or the payment of accrued sick leave at retirement to or for all, or a portion, of officers, employees, and retired employees and their dependents from the county general fund or other sources, the board of retirement may authorize the payment of all, or a portion, of payments of the benefits described in this paragraph from the county advance reserves. (Section 31592.2)

The '37 Act appears to have anticipated the possibility that a retirement system would generate more earnings than anticipated, and would need those Excess Earnings to make up for years where there was a shortfall in earnings. When Excess Earnings surpass a threshold, the '37 Act permits, but does not require, the use of Excess Earnings for certain other purposes. It is not clear from the '37 Act how a retirement system is to use Excess Earnings for these other purposes without contravening federal law and jeopardizing the tax qualification of the retirement plan trust.

The Retirement Board's practice of crediting the assumed interest rate to all reserves except the Market Stabilization Reserve is consistent with the description of Excess Earnings in the '37 Act. While we have concerns about the lack of transparency created by this process, there is no technical defect to the methodology employed by the Retirement Board. We will discuss the Retirement Board's policy for the use of Excess Earnings as part of the benefit policy section of this report.

Retiree Healthcare

Retiree healthcare benefits are currently funded through the Retiree Healthcare Reserve and the Supplemental Retiree Healthcare Reserve. As noted above, these reserves are funded from Excess Earnings and are credited with the assumed rate of earnings regardless of actual earnings.
The GASB valuation indicates that the reserves are sufficient for both current vested and non-vested retiree health benefits. However, based on our analysis, without additional funding, the current assets will not be able to pay this level of benefit indefinitely.

The fact that the vested and non-vested benefits are paid out of the same reserve funds may expose the County to additional liability for vested benefits if the funds prove insufficient. If vested benefits extend to future retirees, it is almost certain that additional funds will be required at some point in the future, and the use of Excess Earnings to pay for non-vested benefits will hasten that moment.

Funding Structure Issues

The retiree healthcare reserves are not currently set up as a 401(h) account within the pension plan. Instead, they are simply a designated reserve. We understand that payments from such a reserve are treated as additional pension benefits for tax purposes and should be subject to income tax. However, SBCERS has treated the designated reserves as

providing non-taxable medical benefits. The County should engage tax counsel to determine the extent of the issue and any potential liability to the County.
In addition to the taxation of benefit payments, the current structure may cause tax qualification issues. SBCERS operates as a retirement system trust fund under Section 401(a) of the Internal Revenue Code of 1986, as amended ("IRC"), and SBCERS receives a tax exemption, pursuant to IRC Section 501(a), on monies accruing within the pension trust fund. The use of SBCERS Excess Earnings to fund retiree healthcare benefits and the administration of the retirement healthcare program through SBCERS may have contravened the qualification requirements of IRC Section 401(a).
The use of SBCERS Excess Earnings to fund retiree healthcare benefits may violate IRC Section 401(a)(2), or the "exclusive benefit rule." This provision provides that, in order for a pension plan to be considered a qualified plan, it must be impossible "for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, purposes other than for the exclusive benefit of [the employer's] employees or their beneficiaries."[1] U.S. Treasury Department regulations specify that, pursuant to this requirement, assets of a retirement plan must only be used for traditional retirement type benefits, a category which does not include payments for medical expenses.[2] The County's direct reliance on SBCERS to pay for retiree healthcare benefits may violate IRC Section 401(a). If so, the IRS could disqualify the SBCERS Plan for this violation of the "exclusive benefit rule."
While the IRC does permit transfers of "excess pension assets" in the pension fund to a 401(h) account under IRC Section 420, the Excess Earnings have not been sufficient to qualify as "excess" for purposes of an IRC Section 420 transfer exception. The funding scheme arguably violated the Section 401(h) exception and the Section 401(a) requirements. Thus, the entire plan could be subject to disqualification as a qualified defined benefit pension plan.
However, it is unlikely the IRS would disqualify SBCERS from the tax exemption it has taken advantage of since inception. Because the County is a governmental, not-for-profit entity, it has no taxable income from which to deduct its contributions to the System, one of the advantages of tax-exempt status. Rather, the primary tax advantage SBCERS has received is the deferral of taxes on the benefits accruing to its participants. Thus, the disqualification of the Plan would primarily hurt the beneficiaries of the system while not adversely affecting the County in any direct manner.
The IRS has a considerable amount of discretion in regard to actions it may take against the County for violations of the IRC. In a recent IRS investigation into the operations of several pension funds of the City

of New York ("New York"), the IRS entered into a Closing Agreement with New York that waived monetary sanctions against the

[1] 26 U.S.C. § 401(a)(2) (West 2006); 26 C.F.R. § 1.401-1(a)(3)(iv). This rule is also codified in Cal. Const. art. XVI, § 17(a)-(b).

[2] 26 C.F.R. § 1.401-1(b)(1)(i). Importantly, the regulation provides an exception for the payment of medical benefits pursuant to IRC § 401(h), which requires the creation of a separate trust within a retirement plan. Id.; 26 U.S.C. § 401(h) (West 2006). The County has not created such a trust.

municipality for similar violations of the IRC's governmental retirement plan qualification requirements and maintained the qualified status of the pension funds.[3] In particular, New York had amended three separate pension trust funds (serving police officers, firefighters, and general employees, respectively) to allow for the transfer of trust assets to a Variable Supplement Fund ("VSF") established within each pension fund.[4] Since the VSFs provided non-pension-related supplemental benefits to retirees in addition to regular pension benefits, the IRS concluded that the diversion of pension trust assets – in excess of $176 million – into the VSFs and to New York violated IRC Section 401(a)(2), the "exclusive benefit rule."[5] The IRS did not contend that the trust arrangements constituted prohibited transaction violations, which would have implicated the disqualification provision of IRC Section 503(a)(1)(B).[6] In lieu of disqualifying the pension trusts from tax-exempt status, the IRS mandated that New York repay the amount of the transferred assets.[7] The IRS also required that New York timely submit legislation to the New York State Legislature to amend the statutes governing the City pension trusts at issue to ensure future compliance with the qualification requirements of IRC Section 401(a)(2).[8]

If the County elects to establish a 401(h) account within SBCERS, the 401(h) account cannot be funded with Excess Earnings, and the 401(h) account must receive its own earnings (not the assumed rate of earnings). Furthermore, the 401(h) account requires that the benefits to be paid from the 401(h) account be clearly defined by a plan document.

[3] Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) (Jan. 31, 2003); Borrelli v. Sec'y of Treasury, 343 F. Supp. 2d 249, 252 (S.D.N.Y. 2004). In Borrelli, active and retired members of the pension plans at issue challenged, among other things, the discretionary action of the IRS to not disqualify the pension plans from tax-exempt status pursuant to IRC Section 503(a)(1)(B), claiming that the IRS acted beyond the scope of its authority. The United States District Court for the Southern District of New York held, among other things, that the plaintiffs had "failed to rebut the discretionary nature of the federal defendants' choice," noting that IRC Section 503(a)(1)(B) "tells the IRS what standard to enforce, but not how to enforce it." Borrelli v. Sec'y of Treasury, 343 F. Supp. 2d 249, 254-55 (S.D.N.Y. 2004) (emphasis in original). In reaching this decision, the court followed Supreme Court precedent that sets forth the presumption against reviewability of a federal agency's decision not to enforce. See Heckler v. Chaney, 470 U.S. 821 (1985).

[4] Borrelli v. Sec'y of Treasury, 343 F. Supp. 2d 249, 252 (S.D.N.Y. 2004).

[5] Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) at 3-4 (Jan. 31, 2003); 26 U.S.C. § 401(a)(2) (West 2006).

[6] 26 U.S.C. § 503(a)(1)(B) (West 2006).

[7] Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) at 4-5 (Jan. 31, 2003). Of particular import in the IRS's decision to not levy fines and disqualify the pension trusts was the financial crisis triggered by the 9/11 attacks: "Due to the unexpected fiscal crisis the City of New York is currently experiencing on account of the terrorist attacks of September 11, 2001, the Commissioner agrees to waive any sanction due from the City of New York as a result of the Commissioner's determination that the City of New York violated section 401(a)(2) of the Code." Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) at 4 (Jan. 31, 2003). Notably, the IRS appears to have provided New York the opportunity to repay the transferred assets over time. The Closing Agreement states: "The Commissioner

will treat subsequent contributions by the City of New York to the New York City Police Department Pension Fund, the New York Fire Department Pension Fund, and the New York City Employees' Retirement System, as repayment of the $176,986,000 transfer." Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) at 4 (Jan. 31, 2003).

[8] The IRS mandated that New York provide timely updates as to the status of the proposed legislation until the New York State Legislature adopted the proposed amendments. Department of Treasury–Internal Revenue Service, Closing Agreement with the City of New York (Replicated Form 906) at 5 (Jan. 31, 2003).

In the Retirement Board's proposal for creating a 401(h) account, when the County makes a contribution to the 401(h) account, the Retirement Board will transfer an equivalent amount from the Retiree Healthcare Reserves to the County advance reserves and treat the transfer as a contribution by the County to the pension plan.

The credit the County would receive from SBCERS toward its pension contribution – in the amount of the County's contribution to the Section 401(h) fund – arguably would result in an indirect diversion of pension funds to cover retiree healthcare premiums. Thus, the System's Excess Earnings, which were otherwise earmarked as pension assets, continued to bear the cost of the County's healthcare "contribution." The funding scheme arguably would violate the Section 401(h) exception and the Section 401(a) requirements.

GASB 43 and 45 Issues

Because the designated reserves are credited with the assumed rate of interest and not actual earnings, there is an implicit transfer to and from the reserves each year. This implicit transfer may violate the requirements of GASB 43 and 45 for considering the assets in completing GASB 43 and 45 disclosures. When the County completes its GASB 45 disclosures, it should be clear about how these assets are treated and the extent to which they can be used for purposes other than retiree healthcare benefits.

Furthermore, a key part of the new GASB disclosures is to report contributions compared to the Annual Required Contribution and the Annual OPEB Cost. Since these benefits have been funded with Excess Earnings, it is not clear what contributions would be reported. GASB's guidance indicates that the County's contribution should be allocated between a contribution for retiree healthcare benefits and a contribution for pension benefits. GASB notes that "the employer is in the position of supporting, directly or indirectly, two benefits." This approach may result in the County making contributions that are less than the Annual Retired Contribution in some years.

3

Benefit Policy

The benefit policy is controlled by the County's Board of Supervisors with some ability of the Retirement Board to affect benefits through the use of Excess Earnings.

Overview of Pension Benefits

Pension benefits are based on final average salary, years of service, and an age-based retirement factor. Final average salary based on highest consecutive 12 months of service.
Retirement factors are as follows:

- General members – 2% at 57 (Plan 5A and Plans 5B)
- Public Safety members – 3% at 55

Benefits vest upon completion of 5 years of service, and monthly retirement benefits may begin as early as age 50 with 10 years of service. There is a 3% annual COLA after retirement.
Members may purchase additional service and there are reciprocity agreements with other public employers.

Use of Excess Earnings

The '37 Act permits the disposition of Excess Earnings in any year when undesignated reserves exceed 1% of total assets. Board policy is to distribute Excess Earnings proportionately between the following reserve accounts:

- Employer Supplemental Benefit Reserve
- Member Supplemental Benefit Reserve
- Retired Supplemental Benefit Reserve

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Because the retiree reserve represents half of the total, the result of the Board policy is that approximately 50% of Excess Earnings are used to provide additional benefits for retirees when Excess Earnings exceed 1% of total assets.

Following this policy, the Board would distribute approximately $29 million in additional retiree benefits this year even though SBCERS is not fully funded. If SBCERS earns the assumed 8.16% interest in each year in the future, it would distribute approximately $77 million to retirees over the next 50 years. Most of this distribution occurs in the first year, but because no earnings are credited to the contingency reserve, the earnings on that reserve create excess earnings, even if SBCERS earns 8.16%. This distribution is relatively small compared to the size of the plan's assets, however, it is very sensitive to actual investment returns. For example, if the plan earns an 11.7% return over the next 5 years, it would distribute approximately $195 million in additional retiree benefits over the next 6 years.
The leverage is even more significant if the plan sustains an average return greater than 8.16% over the long term. For example, a long-term return of 9.6% would result in the distribution of over $3 billion in additional retiree benefits over the next 50 years. We estimate that given the current asset allocation there is a 25% chance of achieving such a return over a long period. However, there is also a 25% chance of only achieving a long-term return of 5.8% or less. Such a low return would not result in a corresponding reduction in retiree benefits. Consequently, the risk-return profile is asymmetric for the County. That is, the benefits of good investment returns are shared with retirees, but the costs of poor investment returns are entirely borne by the County.
While the '37 Act permits the disposition of Excess Earnings when they exceed 1% of total assets, it does not indicate that it is prudent to do so. In fact, it may be argued that it is not prudent to do so if the pension benefits are not first fully funded, and perhaps more than fully funded. The County and the Retirement Board may want to seek legal counsel's advice as to the fiduciary standards applicable to a decision to use Excess Earnings to provide additional benefits.

When a plan is fully funded based on all of the actuarial assumptions, that means there is a 50% chance that there is not enough money to pay all of the benefits. Actuarial assumptions are the actuary's best estimate of future plan experience, but there is significant variance around the best estimate. Any time Excess Earnings are used to grant additional benefits, there is a cost to the County in that it increases the likelihood that additional County contributions will be required in the future to fund the pension benefits. Regardless of how overfunded the plan may be, there is an additional cost.

Analysis Used to Grant Benefit Improvements

For the benefit improvements granted effective December 31, 2000, the assumptions used to price the improvement were from the December 31, 1999 actuarial valuation. There were no changes in assumptions or sensitivity to alternate retirement experience reflected in the analysis of the proposed benefit improvements. Given the increase in benefits, some effect on rates of retirement might have been anticipated, if only for a short period of time. We believe it would be wise for the Retirement Board and the Board of Supervisors to

request some analysis of the sensitivity of the cost of the benefit changes to different assumptions in order to make a more informed decision.

In fact, the experience study performed shortly after these benefit increases were granted found that actual retirements among safety employees were 176% of expected retirements. In the report, the actuary noted, "Based on our expectation that members were waiting to retire after new benefits were implemented, no adjustments were made to Service Retirement rates."

According to the actuary, the benefit improvements (excluding the change to final average salary) added $28.4 million to liabilities. However, between December 31, 2000 when these benefits were adopted and June 30, 2004, there were demographic losses (excluding salary losses) in each valuation totaling $42.8 million. It is not clear how much of these losses are attributable to the benefit improvements.

In addition to the changes to the benefit formula, the averaging period for final average salary was reduced to one year. There does not appear to be any discussion about potential salary spiking that can occur with the shortened averaging period even though other systems have experienced some salary spiking with a short averaging period.

The concern over salary spiking is that some members are able to manipulate their final average pay to be much larger than their historical pay and significantly, and unexpectedly, increase their retirement benefits. Usually, relatively few members can do it, but the whole system pays for it.

According to the actuary, the change to a one-year final average salary increased liabilities by $26.5 million. However, in the following three valuations, there were salary losses of $13.1 million, retiree losses of $11.5 million, and salary losses for new retirees of $9.7 million. It appears that the $9.7 million loss may be directly attributable to the change to a one-year averaging period, but it is not clear if the other losses may also be attributable to the change.

When these benefit improvements were made, it also appears that the decision was based on the actuarial value of assets and not the market value of assets. With the stock market beginning to decline, the funded status may not have been as solid on a market value basis as on an actuarial value basis at the time the final decision was made. We believe that the funded status on a market value basis should be used when making decisions to improve benefits.

The actuary estimated a total increase in liability due to these benefit improvements of $54.9 million, but an increase of only $25.3 million in the UAAL. The reason for this discrepancy is that there were transfers from special reserves of $29.6 million. Special reserves are accounted for as both assets and liabilities, so when a pension benefit improvement is made, it appears to be free because assets and liabilities for it had already been established by the Retirement Board and disclosed as a liability under GASB 25. We believe this practice to be inappropriate under GASB 25 and to add to the opacity of an already confusing system.

Finally, in making these benefit improvements, it appears there was a budget to spend to reduce the funded status of the system to 100%. As noted above, a funded ratio of 100% does not mean that no future

contributions will be required for the benefits already earned or that the benefit improvements are free. In fact the benefit improvements may have cost significantly more than originally estimated.

Retiree Healthcare Benefits

Explicit Subsidy

Benefits were initially established pursuant to a settlement agreement, and the Retirement Board used its authority under Sections 31691 and 31691.1 of the '37 Act to expand these benefits. Prior legal analysis indicates that the benefits granted pursuant to the settlement agreement are likely to be considered vested benefits, but that, by definition, the expanded benefits granted by the Retirement Board are not vested. The settlement agreement itself appears to only apply to members who had retired under SBCERS on or before June 24, 1988. However, in practice, the benefits under the settlement agreement have been provided to all retired members regardless of date of retirement. This practice may result in a determination that these benefits are also vested.
In the settlement agreement, the County agreed to provide a retiree healthcare subsidy of $8 per month per year of service for members of the system who had retired on or before June 24, 1988 and who participated in a County sponsored health plan. For those who did not participate in a County sponsored health plan, the subsidy was $1.47 per month per year of service. Between 1996 and 2002, the Retirement Board has used Excess Earnings to expand the benefits to $15 and $4 per month per year of service respectively.

GASB 43 and 45

Under GASB 43 and 45, the substantive plan must be valued. The substantive plan is the plan as understood by the County and its employees. Since employees have not been informed of the non-vested nature of the expanded benefits granted by the Retirement Board, it is reasonable to interpret the substantive plan to include the non-vested benefits. As a result of this structure, when the Retirement Board expands retiree healthcare benefits, it creates a GASB 45 liability for the County.
Alternatively, if the benefits as understood by members are non-vested and can be reduced to the extent there are insufficient earnings, the liability under GASB may be limited to the vested benefits plus the assets set aside for non-vested benefits.

401(h) Account

In the proposal put forth by the Retirement Board to establish a 401(h) account, it appears that the County would make the expanded benefits adopted by the Retirement Board vested. In the future, when the Retirement Board wanted to use Excess Earnings to fund retiree healthcare benefits, it would request that the County make contributions to the 401(h) account in exchange for crediting Excess Reserves to County advance reserves in the pension plan. This arrangement is unsavory in its appearance and may be viewed as contravening the tax qualification requirements of the Internal Revenue Code.

Since a 401(h) account is a recognized, tax-efficient vehicle for providing retiree medical benefits, the County may want to consider creating such an account for the vested benefits if it can be assured that the Excess Earnings intended to fund these benefits won't just be diverted to expand benefits further.

Potential Implicit Subsidy

Pre-Medicare retirees who select coverage under the County of Santa Barbara insurance options pay a premium that is 18-19% higher than the active premium. We have not reviewed the methodology used to set active and retiree premiums, but the difference in premiums may indicate that there is an implicit subsidy between actives and retirees.
Under GASB 45, the implicit subsidy would need to be valued and disclosed on the County's financial statements. The liability associated with an implicit subsidy can significant.

Premium	Payments per Year	Annual Premium	Retiree Excess %

Low HMO Plan			
Active	$128	26	$3,328
Retiree	$327 12	$3,927	18%
High HMO Plan			
Active	$187	26	$4,869
Retiree	$481 12	$5,776	19%
POS Plan			
Active	$272	26	$7,073
Retiree	$702 12	$8,421	19%
PPO Plan			
Active	$136	26	$3,548
Retiree	$349 12	$4,192	18%

The County may want to ensure that retiree premiums are set such that there is no implicit subsidy that would create a liability under GASB 45.

Pension Protection Act

The Pension Protection Act allows safety members to use up to $3,000 per year from their government pension benefit to purchase retiree healthcare benefits tax free effective January 1, 2007. County and SBCERS may want to research to determine if this benefit is appropriate for County safety members.

4

Investment Policy

The investment policy is a key determinant of the long-term cost of a pension plan. Benefits must be paid from contributions and investment earnings less expenses. If a plan can achieve higher rates of return, fewer contributions will be required. If the higher rates of return come with greater volatility, contribution rates are likely to be somewhat volatile as well.

Asset Allocation

The asset allocation described in the investment policy determines the expected return and the expected volatility for the portfolio. The table below shows the target asset allocation for SBCERS.

Asset Class	Target Allocation
Russell 1000 Index	21%
Broad Growth	8%
Large Value	13%
Small Cap	5%
Total Domestic Equities	47%
Non-US Global	15%
Emerging Markets	2%
Total International Equities	17%
Fixed Income	25%
Real Estate	5%
Alternatives	5%
Cash	1%
Total Portfolio	100%

A higher expected rate of return reduces costs for members and the County. Greater volatility increases the likelihood of Excess Earnings, resulting in potentially higher benefits for members. However, greater volatility also increases the likelihood of poor earnings, resulting in potentially higher costs for the County.

Using Mercer Investment Consulting’s capital market assumptions as of January 1, 2006, the SBCERS asset allocation is expected to yield an annual return of approximately 7.7%. As shown in the table below, however, there is significant variability in the expected return for each individual year, and even a fair amount of variability over longer time periods.

		Projection Horizon (years)			
		1	5	10	20
Percentiles	5th	-13.8%	-1.9%	0.9%	2.9%
	25th	-1.1%	3.8%	4.9%	5.8%
	50th	7.7%	7.7%	7.7%	7.7%
	75th	16.6%	11.7%	10.5%	9.7%
	95th	29.2%	17.4%	14.5%	12.5%

Under the current structure, members will have a significant appetite for risk as it reduces their contribution rates and increases the likelihood of additional benefits through excess earnings. The County, however, should be more risk averse as the short term decrease in costs from higher expected investment earnings comes with an asymmetrical risk. If investment returns exceed expectations, part of the gain becomes increased benefits instead of lower cost, but if investment returns fall short of expectations, the County incurs the entire cost of the shortfall.
The benefit structure (including current Retirement Board policies) creates conflicting interests between members and the County with respect to the investment policy. It is not clear how these conflicting interests are to be balanced with the fiduciary obligations of the trustees. The County may wish to pursue changes such that the interests with respect to the investment policy do not conflict.

5

History of Funded Status

SBCERS reported a surplus of $25.6 million as of December 31, 2000 before the adoption of the benefit improvements. By June 30, 2005, this surplus had been replaced by a deficit of $243.8 million. The SBCERS actuary provided a reconciliation showing the following causes of the decrease of $269.4 million in funded status.

Cause	Amount
Benefit Improvements (12/31/2000)	$25.3
Investment Losses	$126.8
Demographic Losses	$75.6
Assumption Changes (6/30/2003)	$23.4
Interest and Contribution Timing	$18.3
Total	$269.4

We did not attempt to replicate these calculations, but a number of the concerns we have raised in this report can be illustrated with this analysis. First, the analysis is based on the actuarial value of assets instead of the market value resulting in a distortion of when the investment losses were actually incurred. The table below compares the UAAL calculated on an actuarial value of assets to that calculated on a market value of assets.

Valuation Date	Actuarial Value UAAL	Market Value UAAL
12/31/1999	$(1)	$(180)

12/31/2000	$(26)	$(38)
12/31/2002	$68	$284
6/30/2003	$108	$285
6/30/2004	$200	$232
6/30/2005	$244	$211

Based on market value, there was actually a $391 million change in UAAL during this period, including a $464 million drop between December 31, 1999 and December 31, 2002. It is not clear from the data what the actual funded status was at the time the benefit improvements were actually adopted, but if a current market value funded status had been reported at that time, it may have impacted the decision to improve benefits.

Our second comment on this illustration is that it includes the non-pension reserves as both assets and liabilities even when no real liability had been established for the reserve. As a result, the benefit improvements made effective December 31, 2000 appear to only increase the UAAL by $25 million when the actual cost was nearly $55 million using the actuary's estimates. There was a transfer of nearly $30 million from other reserves that had been treated as both an asset and a liability as if there was a previous commitment to make this benefit increase.

Third, some benefit increases (e.g., ad hoc retiree colas) do not appear on the reconciliation, presumably because they were funded from special reserves that were already considered a liability.

Finally, as we noted above, some portion of the $75.6 million in demographic losses may be attributable to the benefit improvements. Some additional information or analysis from the actuary would be required to determine how much, if any, of these losses are directly related to the benefit improvements.

The methodology used to illustrate the changes is not transparent. It combines in the effects of reserving practices and actuarial smoothing techniques to obscure the actual impact of the underlying changes. Nevertheless, it is clear that the dominant impact on the development of the UAAL was poor investment returns between December 31, 1999 and December 31, 2002. It is because of the risk of incurring such investment returns that we are concerned about the current policy using Excess Earnings.

6

Summary and Recommendations

In summary, we have a number of concerns about how the retirement system is managed. Our report focuses on the areas of concern, but is not meant to imply that the system is currently in a crisis. The issues raised are intended to help the County better understand and manage the retirement system in the future. SBCERS is currently reasonably well funded and the primary underlying methodologies used are sound and lead to a fully funded system. However, there are complex interactions embedded in the retirement program that may affect the future soundness of the system if they are not well understood by all parties.

The current structure is not transparent in how the system operates which may lead to poor decisions in the future. There are also some technical issues that should be addressed immediately in order to limit their potential impact.
In particular, we have the following concerns:

The mechanism for paying retiree healthcare benefits does not appear to be consistent with our understanding of federal law potentially jeopardizing the tax qualification of SBCERS and tax returns for all retirees receiving healthcare benefits.

The proposal to establish a 401(h) account appears to vest benefits that are not currently vested and may contravene Section 401(a).

There may be an implicit retiree healthcare subsidy that should be valued under GASB 45.

The SBCERS policy for using Excess Earnings appears to be independent of fiduciary responsibilities for protecting pension benefits and creates an asymmetrical risk distribution for the County.

SBCERS appears to view benefits that are fully funded through Excess Earnings as creating no additional cost to the County. Any benefit improvement has a cost.

The number of different reserve accounts established by SBCERS and the discretionary transactions between those reserve accounts make the system less transparent than it should be.

The practice of crediting reserves with the assumed rate of earnings each year instead of the actual rate of earnings distorts funding levels, is not transparent and may prevent the recognition of those assets for purposes of GASB 43 and 45.

The practice of establishing reserves as both assets and liabilities under GASB 25 distorts the reported funded status and makes benefit improvements appear less costly than they really are.

The analysis used to grant benefit improvements failed to test the sensitivity of assumptions and may have underestimated the cost of those benefit improvements.

When actuarial assumptions are next reviewed, particular attention should be paid to the following:

– retiree mortality,

– rates of retirement for public safety,

– salary increases in year of retirement, and

– inflation and wage growth.

With each of these concerns, we recommend that the County work with the Retirement Board to take appropriate corrective action or to investigate alternatives and develop appropriate policies. The overriding objectives of any changes should be:

- to confirm compliance with applicable laws and regulations,
- to improve the stability of the retirement system, and
- to improve the transparency of the retirement system.

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