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County of Santa Barbara Pension Obligations
Implications of Recent Investment Losses

Bill Hallmark

Agenda

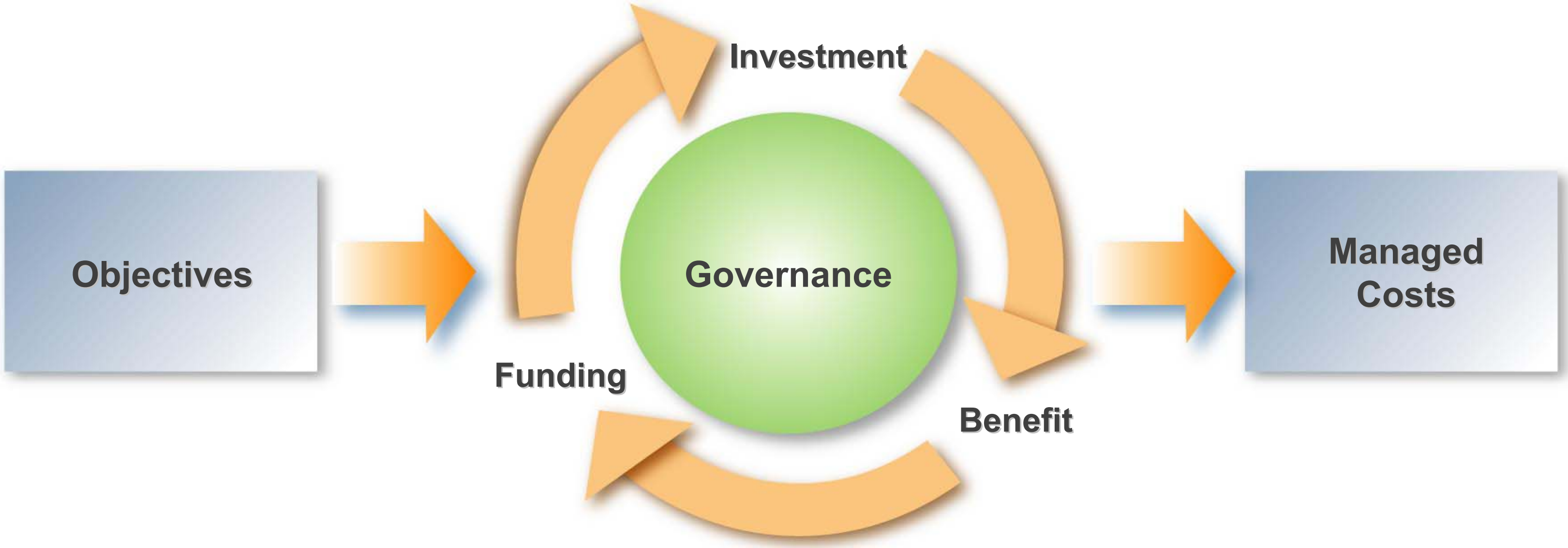
- Overview of Managing Retirement Programs
- Impact of Recent Market Experience
- Options to Manage Costs and Risks

Overview of Managing Retirement Programs

County of Santa Barbara

Overview of Managing Retirement Programs
Fundamental Framework

Total Employer Contributions = Benefits Paid - Investment Earnings – Employee Contributions



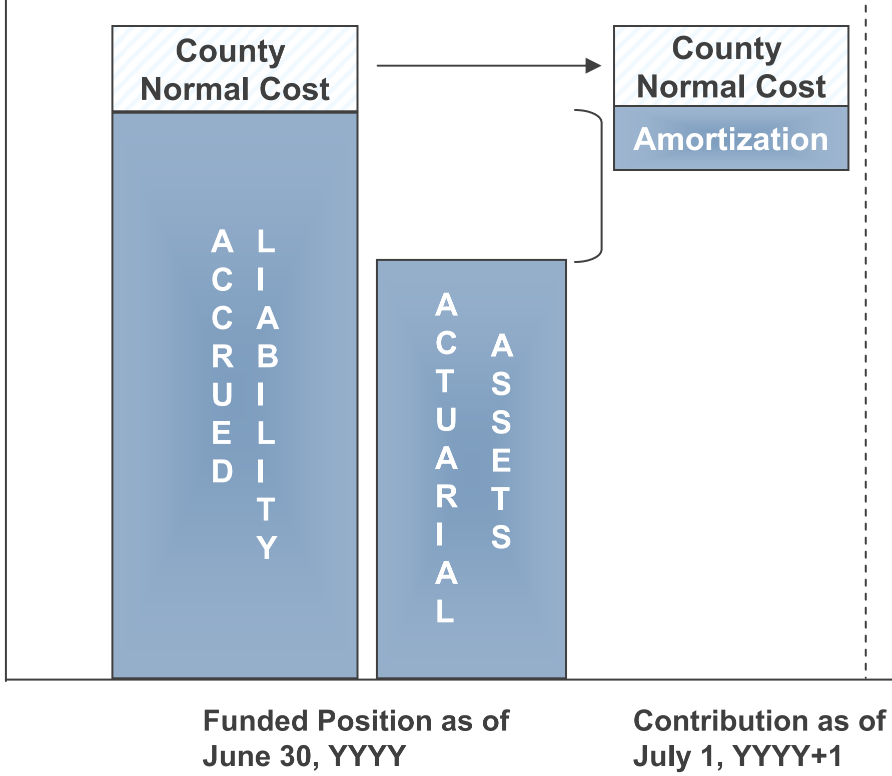
Actuarial methods primarily affect the timing of contributions

Overview of Managing Retirement Programs
Fundamental Framework

Benefit Policy	Investment Policy	Funding Policy
County Controlled	**Retirement Board Controlled**	
▪ Affects long-term cost of plan for employees and the County ▪ Defines: – When benefits are paid – How much is paid – How long benefits are paid – Options available to members ▪ Primarily controlled by County, but appear to be some decisions by Retirement Board related to "excess earnings"	▪ Affects long-term cost of plan for employees and County ▪ Affects expected investment return ▪ Determines volatility of investment returns ▪ Determines likelihood of "excess earnings"	▪ Does not affect long-term cost of plan, but does affect level of employee contributions ▪ Determines timing of contributions and cost recognition ▪ Includes all actuarial methods and assumptions

Overview of Managing Retirement Programs
Funding Policy Theory

County Contribution Rate



Theoretical Cost Allocation

- The **actuarial accrued liability** represents the liability attributable to prior service by the cost method.
- The **normal cost** represents the increase in liability attributable to an additional year of service.
- The **actuarial value of assets** can equal the market value, but is usually a smoothed value.
- The **unfunded actuarial accrued liability** is usually amortized as a level percentage of payroll over a period of up to 30 years.

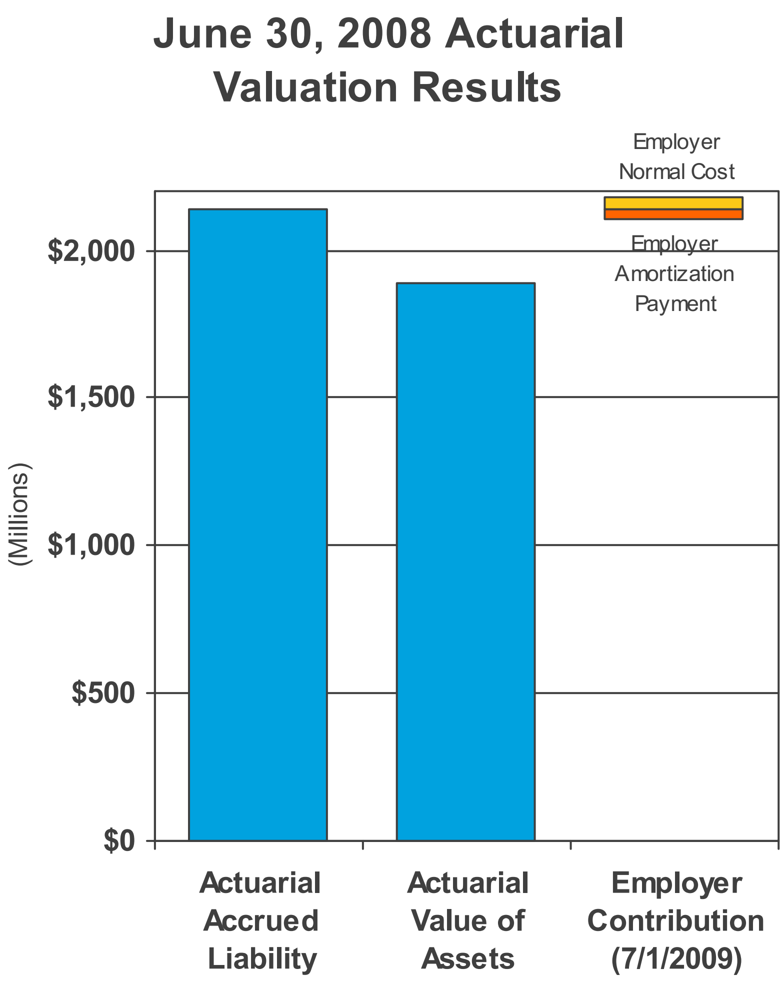
Overview of Managing Retirement Programs
Funding Policy Theory

Typical Objective	Comment
Stable Contribution Rates	Ideally, County contribution rates would be consistent from year to year. The most common methods to stabilize contribution rates are the selection of a long amortization period and smoothing asset values over a period of years.
Predictable Contribution Rates	Stable contribution rates are more predictable, but there is also usually a delay between the completion of the valuation and the implementation of a new contribution rate to allow the County to budget for any changes.
Protect Funded Status	Actuarial methods target a funded status of 100%. The shorter the amortization period and the less asset smoothing used, the more quickly the target is attained.
Generational Equity	Deferring costs today may increase the cost to future generations of taxpayers and employees. Shorter amortization periods and more conservative assumptions tend to protect future generations.
GASB Compliance	Amounts reported in the CAFR must comply with parameters established by GASB. Most systems also prefer the contributions to follow these standards.
Transparency	In order to be able to quickly communicate the status of a retirement system to a variety of stakeholders, many are seeking more transparent methods while others may not value additional transparency.

Overview of Managing Retirement Programs
Funding Policy Theory

- Key Assumptions
  – Investment Return on Assets
  – Salary Increases
  – Mortality Rates
  – Retirement Rates
  – Disability and withdrawal rates
- Assumptions are intended to represent the expected median outcome
  – A valuation produces the median expected cost of the retirement program
  – There is a wide range of potential outcomes
  – A plan that is 100% funded has a 50% chance of not having enough assets and a 50% chance of having more than enough assets to pay for past service benefits
  – County may want to manage against the risk of negative outcomes, as it bears the consequences of this risk

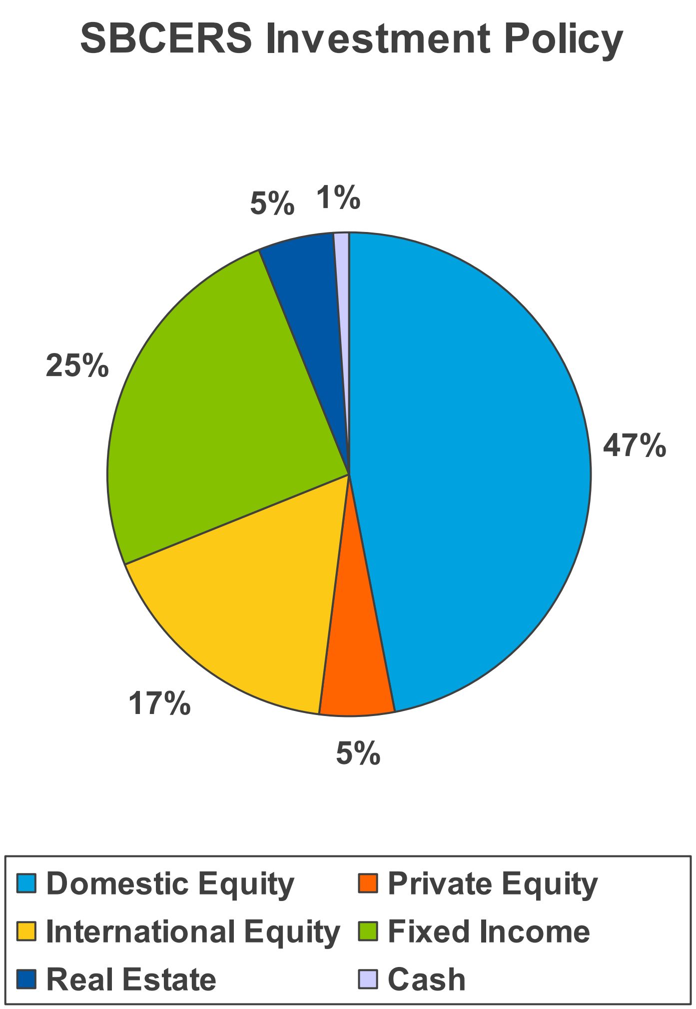
Overview of Managing Retirement Programs
SBCERS' Funding Policy



- SBCERS assumes an investment return of 8.16%
- To stabilize contribution rates, assets are smoothed over a 5-year period. As of 6/30/2008, the actuarial value of assets is $1.89 billion compared to a market value of $1.76 billion
- To balance the stability of contribution rates with protecting the funded status, SBCERS amortizes each new year's gain or loss over 15 years. The total Unfunded Actuarial Accrued Liability is $244 million, resulting in an amortization payment of $29.7 million for the year beginning July 1, 2009
- The employer normal cost is $46.3 million for a total contribution of $76.0 million for the year beginning July 1, 2009

Overview of Managing Retirement Programs
SBCERS' Investment Policy

- The investment policy established by SBCERS affects:
  - Employee contribution rates
  - Short and long-term County contribution rates
  - Availability of "excess earnings"
- More aggressive investment policies result in:
  - Higher expected returns,
  - Lower employee contribution rates,
  - Lower short-term County contribution rates,
  - Lower ***expected*** long-term County contribution rates,
- However, more aggressive policies also produce more volatility, leading to:
  - Greater variation in County contribution rate, and
  - A greater likelihood of "excess earnings" that the Retirement Board may allocate to additional benefits, increasing County costs.



Overview of Managing Retirement Programs
SBCERS' Investment Policy

Percentiles	Projection Horizon (years) 1	5	10	20
5th	-13.5%	-1.7%	1.1%	3.0%
25th	-0.9%	3.8%	4.9%	5.7%
50th	7.7%	7.7%	7.7%	7.7%
75th	16.2%	11.5%	10.4%	9.6%
95th	28.5%	17.0%	14.2%	12.3%

- Using Mercer Investment Consulting's capital market assumptions as of 10/1/2008, the SBCERS asset allocation is expected to yield an annual return of approximately 7.7%
- There is significant variability, however, in the expected return for each individual year, and even a fair amount of variability over longer time periods
- 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, on the other hand, bears the negative consequences of this investment risk. It has to balance the risk of poor investment returns against the additional expected cost of a more conservative investment policy.

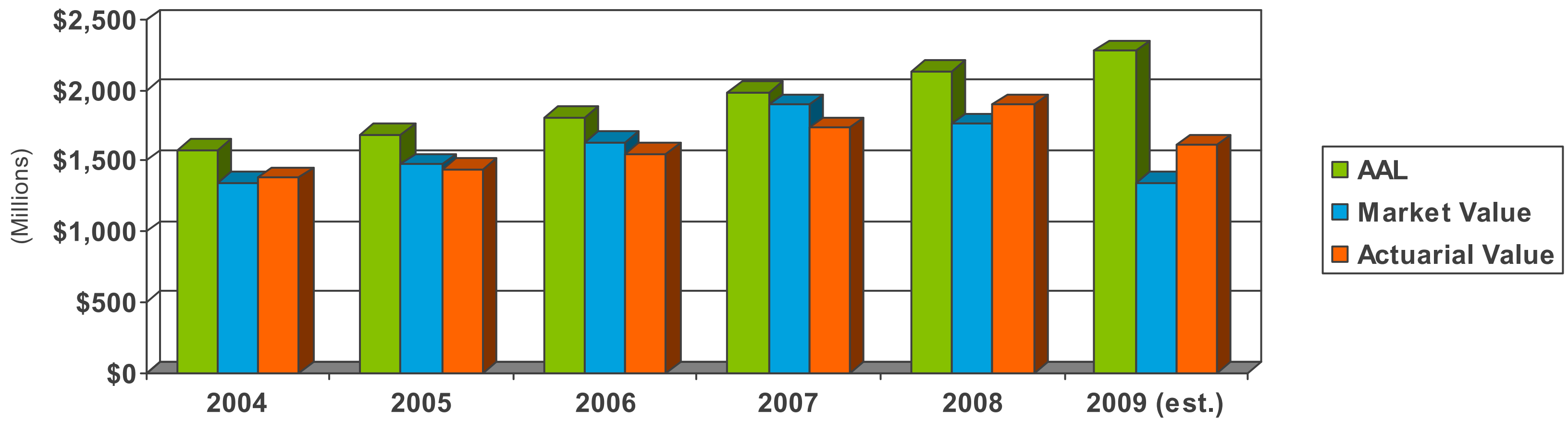
Impact of Recent Market Experience

County of Santa Barbara

Impact of Recent Market Experience
Overview

- Over the last several months, the chaos in the markets has caused significant investment losses for pension plans.
- The Center for Retirement Research at Boston College estimated that 109 state pension plans:
  - Lost approximately $865 billion in the last year
  - Average funded status declined from 86% to between 61% and 66%
  - Would need annual returns of 52% to return to 2007 funding levels by 2010, and
  - Would need annual returns of 18% to return to 2007 funding levels by 2013
- Unfortunately, SBCERS experienced similar investment losses
  - The losses will need to be made up by a combination of investment gains and County contributions
  - If a system loses 50% of its assets, it needs to achieve a return of 100% to “bounce back”

Impact of Recent Market Experience
SBCERS' Assets and Liabilities



- Over the 5-year period ending June 30, 2009, we estimate that SBCERS' liabilities will have grown from about $1.6 billion to $2.3 billion.
- Based on actual asset returns through October, index returns through November, and median expected returns through June 30, 2009, we estimate that SBCERS' assets will have remained essentially unchanged at $1.35 billion from June 30, 2004 to June 30, 2009.
- SBCERS' would need approximately an 80% investment return to reach 100% funded by June 30, 2010, and a 45% return to reach 80% funded on a market value basis.

Impact of Recent Market Experience
SBCERS' Projected Investment Return

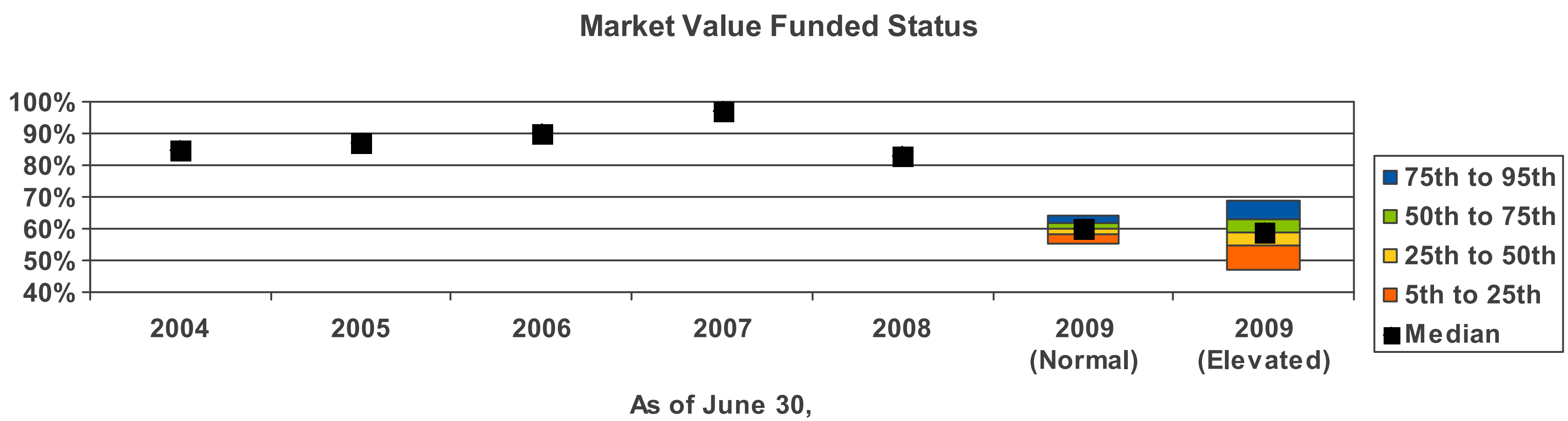
Given the current chaos in the markets, asset models may not accurately reflect the range of potential returns. The figures shown below are intended to provide a sense of potential outcomes, but are not intended to be predictions.

- Instead of using just the median expected return to project SBCERS' assets from December 1, 2008 to June 30, 2009, we examined a range of potential returns based on Mercer Investment Consulting's capital market assumptions.
- Using our normal model, returns for the period from 6/30/2008 to 6/30/2009 ranged from -16.4% in the 95th percentile to -28.4% in the 5th percentile.
- The volatility of the capital markets, however, has been significantly greater than what we normally model. To provide a sense of how this elevated volatility might affect investment returns, we adjusted our model to double the volatility of all equity asset classes. In this case, returns range from -10.1% in the 95th percentile to -38.3% in the 5th percentile.

Projected Investment Return 6/30/2008 – 6/30/2009

Percentile	Normal Volatility	Elevated Volatility
5th	-28.4%	-38.3%
25th	-24.7%	-29.2%
50th	-22.2%	-23.3%
75th	-19.8%	-17.7%
95th	-16.4%	-10.1%

Impact of Recent Market Experience
SBCERS' Funded Status

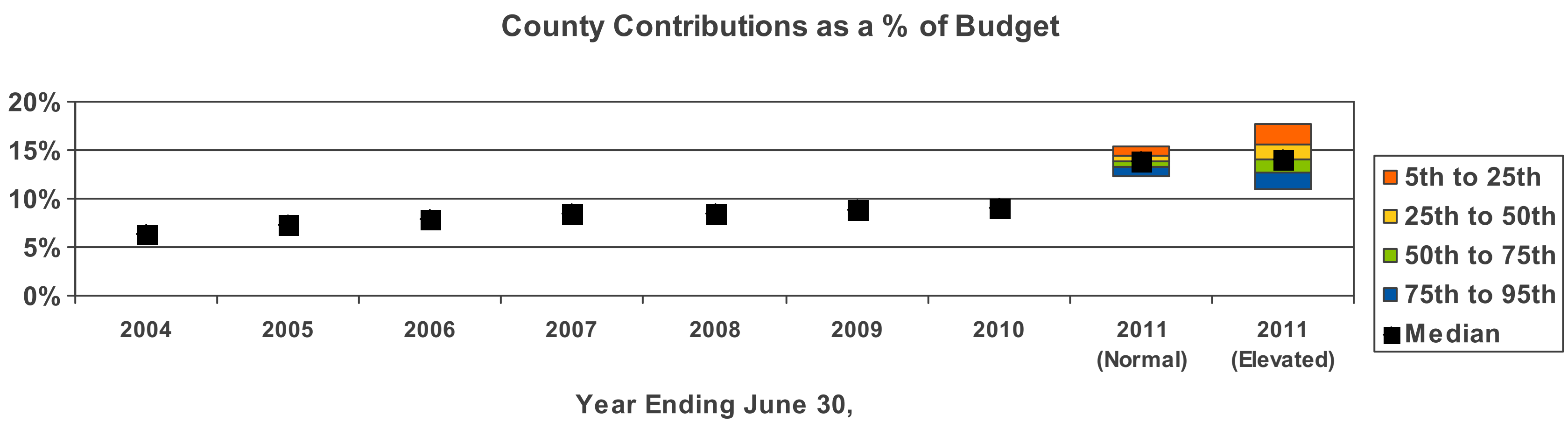


- SBCERS' funded status based on the market value of assets improved consistently from 2004 through 2007, but has dropped significantly since.
- The extent of the decline in funded status as of June 30, 2009 is unknown at this time, but based on the elevated volatility model, it ranges from 47% in the 5th percentile to 69% in the 95th percentile. By comparison, the funded status as of June 30, 2007 was approximately 97% on a market value basis.
- This range in funded status translates to an unfunded liability of between $700 million (95th percentile) and $1,200 million (5th percentile)

Impact of Recent Market Experience
Employer Contributions to SBCERS

- Even as funded status improved, the dollar amount of contributions to SBCERS increased, in large part due to increases in total payroll.
- Using the current methods adopted by SBCERS, required employer contributions are expected to increase from about $76 million in the 2009-10 fiscal year to between $93 million (95th percentile) and $150 million (5th percentile) using the elevated volatility scenario. The majority of employer contributions are paid by the County (approximately $65 million of the total $76 million in 2009-10).
- These contribution rates reflect the asset smoothing in the current methods. Consequently, as the full losses of 2009 are reflected, contribution rates can be expected to climb even higher.

Impact of Recent Market Experience
County Contributions to SBCERS as a % of Budget



- County contributions to SBCERS have increased from 6.3% of budget in FYE 2004 to an estimated 9.1% for FYE 2010
- Using the current methods adopted by SBCERS, required County contributions as a percent of budget are expected to increase to between 10.9% (95th percentile) and 17.6% (5th percentile) using the elevated volatility scenario.
- As on the previous slide, these rates reflect the asset smoothing in the current methods. As the full losses of 2009 are reflected, the portion of the County budget dedicated to plan contributions will continue to climb.

Impact of Recent Market Experience
Future County Contributions to SBCERS

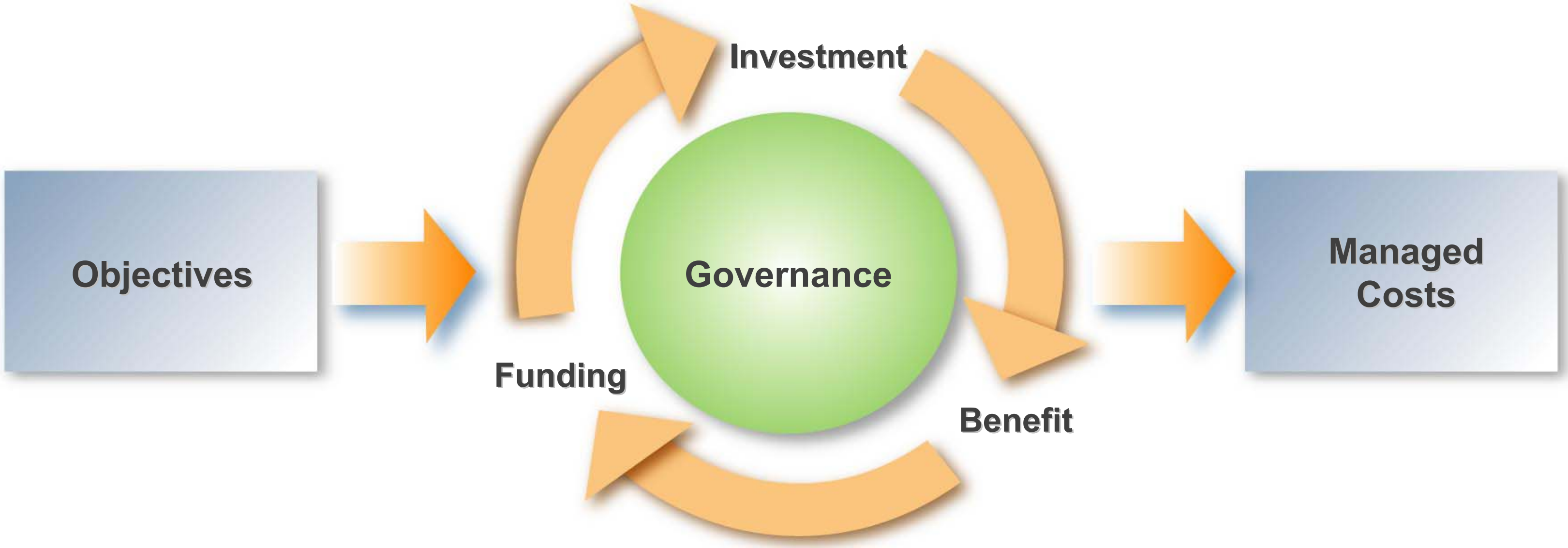
- Predictions of future investment returns range from bounce-back scenarios to a long period of poor returns similar to what Japan experienced.
- We cannot predict the future, but recommend that the County consider a range of options to manage the risks of significant ongoing contribution levels.

Options to Manage Costs and Risks

County of Santa Barbara

Options to Manage Costs and Risks
Fundamental Framework

Total County Contributions = Benefits Paid - Investment Earnings – Employee Contributions



Actuarial methods primarily affect the timing of contributions

Options to Manage Costs and Risks
Basic Choices

- Funding Policy
  - Actuarial methods could be modified to partially delay increases in contributions, giving the market time to recover, or to permanently establish a longer period over which to pay for the unfunded liability
  - If the market doesn't recover, higher contributions are effectively pushed to the future
  - Given the extraordinary experience of the last year, we believe some adjustment to methods is appropriate, and a preliminary review of options to consider shows a range of employer contributions for the 2010-11 fiscal year that varies by $40 million with varying long-term consequences
  - Requires action by SBCERS Board

Options to Manage Costs and Risks
Basic Choices

- Funding Policy (cont.)
  - Starting with a projected market value UAAL of $914 million, the table shows the 1st year and total dollar amount of the amortization payments
  - Using a level percent of pay method, payments increase 4% each year
  - In general, the longer the amortization period, the lower the initial payment and the greater the total payments

Amortization Method	1st Year Payment	Total Payments
15-Year Level %	$80.6	$1,613.8
20-Year Level %	$65.9	$1,962.8
30-Year Level %	$51.8	$2,905.4
30-Year Level $	$76.2	$2,284.8

Options to Manage Costs and Risks
Basic Choices

- Investment Policy
  – Much of the ongoing risk retained by the County is investment risk. Higher investment returns will reduce required County contributions and lower returns will increase required County contributions
  – There is a risk that the SBCERS Board may view “excess earnings” as available to provide additional benefits even if not 100% funded
  – Requires action by SBCERS Board
- Benefits Policy
  – Changes to the benefit structure are subject to collective bargaining and legal requirements
  – Requires action by the County Board of Supervisors

Options to Manage Costs and Risks
Recommendation to Board of Supervisors

- Direct staff to study options to manage the costs and risks associated with retirement benefits and return to the Board in sixty (60) days with recommendations on:
  - Guiding principles for the County with respect to the funding of retirement benefits to be communicated to the Santa Barbara County Employees Retirement System (SBCERS)
    - Principles may include transparency, generational equity, contribution rate stability and predictability, protection of funded status, etc.
  - County recommendations to SBCERS on changes in the current funding policy to better meet these guiding principles in light of the current market environment

Options to Manage Costs and Risks
Recommendation to Consider

- Funding Policy
  - Develop County principles to be used by staff and communicated to SBCERS Board members
    - Stability of contribution rates,
    - Transparency,
    - Predictability of contribution rates,
    - Protection of funded status,
    - Generational equity
  - For the short-term, consider one of the alternative methods we illustrated for staff (or a variation)

Method	Projected Contributions for FYE 6/30/2011
Current 15-Year Layered Amortization	$117
Option 1 CalPERS Method	$87
Option 2 20-Year Fresh Start Amortization	$98
Option 3 Option 2 + Eliminate Asset Smoothing Corridor	$77
Option 4 Rate Collar	$93
Option 5 One-Time 30-Year Amortization	$104

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