MERCER
Human Resource Consulting

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Retirement System Evaluation
County of Santa Barbara

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Agenda

- Overview
- Retirement Plan Financial Management
- Funding Policy
- Benefit Policy
- Investment Policy
- Historical Funded Status
- Summary and Recommendations

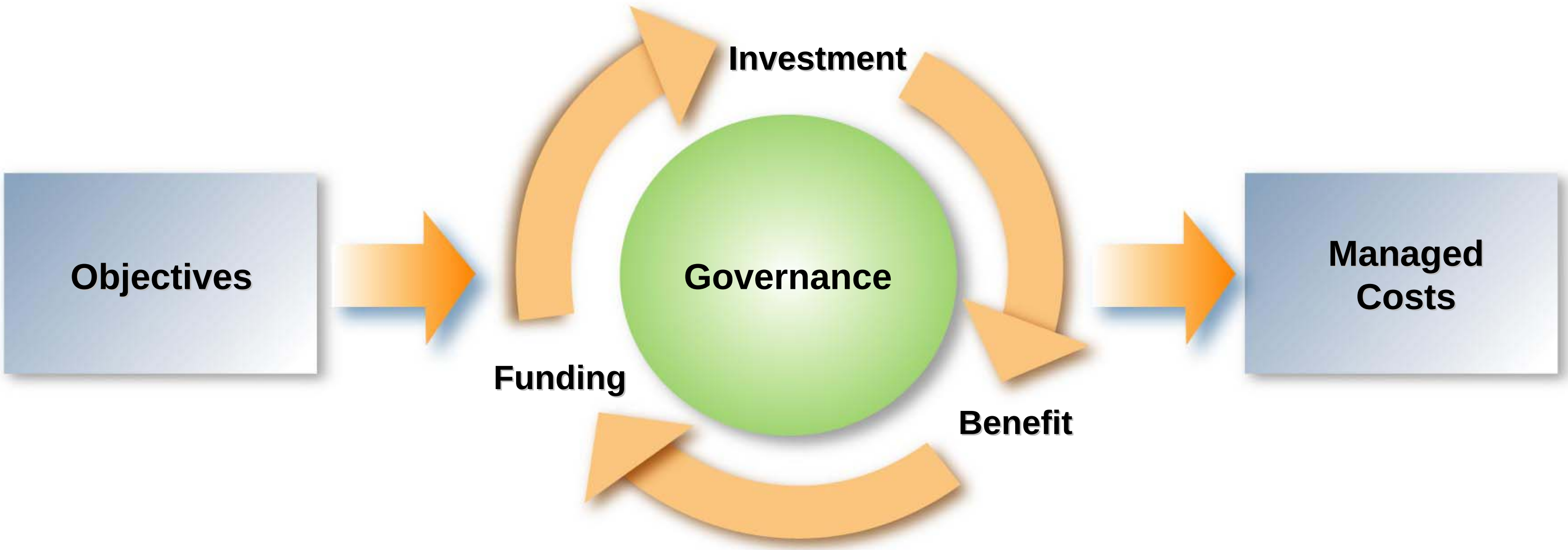
Overview

Overview

- High level evaluation
  - Based on documents provided
  - We didn't attempt to reproduce calculations from data
- Basic conclusions
  - SBCERS is being funded in an actuarially sound manner
  - Some practices and policies could jeopardize funding status in the future
  - Lack of transparency makes it difficult for decision makers and stakeholders to understand the implications of decisions
  - There are some issues of technical compliance

Retirement Plan Financial Management Framework

Retirement Plan Financial Management
Potential Strategies for Managing Costs



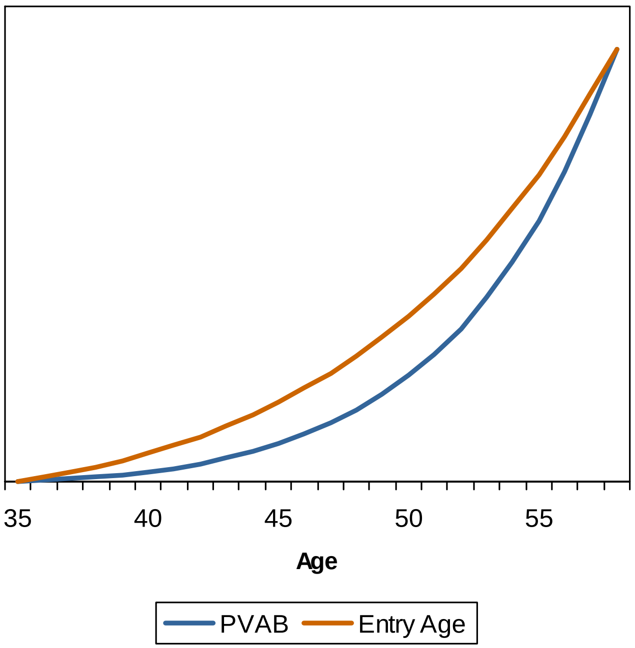
Retirement Plan Financial Management
Potential Strategies for Managing Costs

Benefit Policy	Investment Policy	Funding Policy
▪ Affects long-term cost of plan ▪ 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	▪ Affects long-term cost of plan ▪ Determines expected return and volatility of returns ▪ Determines likelihood of excess earnings	▪ Does not affect long-term cost of plan ▪ Determines timing of contributions and cost recognition ▪ Includes all actuarial methods and assumptions

Funding Policy

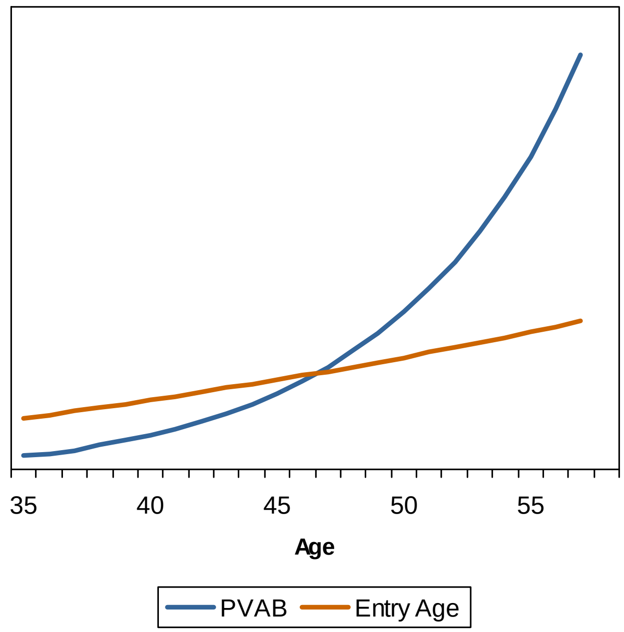
Funding Policy
Theoretical Overview

Comparison of Accrued Liability



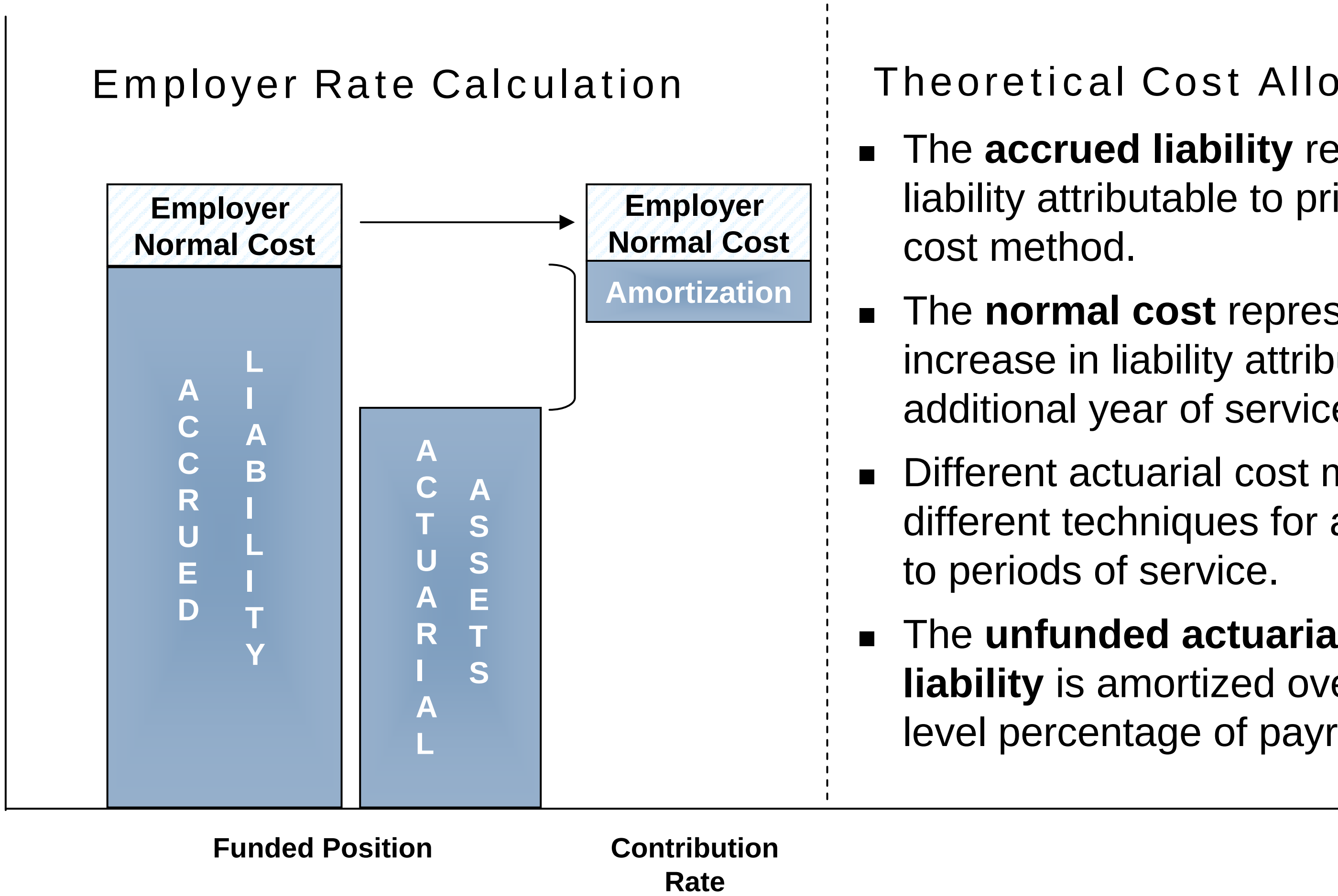
- Present value of accrued benefits to date—PVAB—(based on current service and pay) increases rapidly as member approaches retirement
- Actuarial methods allocate these costs evenly across an employee's career

Comparison of Normal Cost



- PVAB normal cost shows the pattern in which benefits are actually earned
- The Entry Age Normal cost method allocates accruals as a level percentage of payroll over an employee's career

Funding Policy
Theoretical Overview

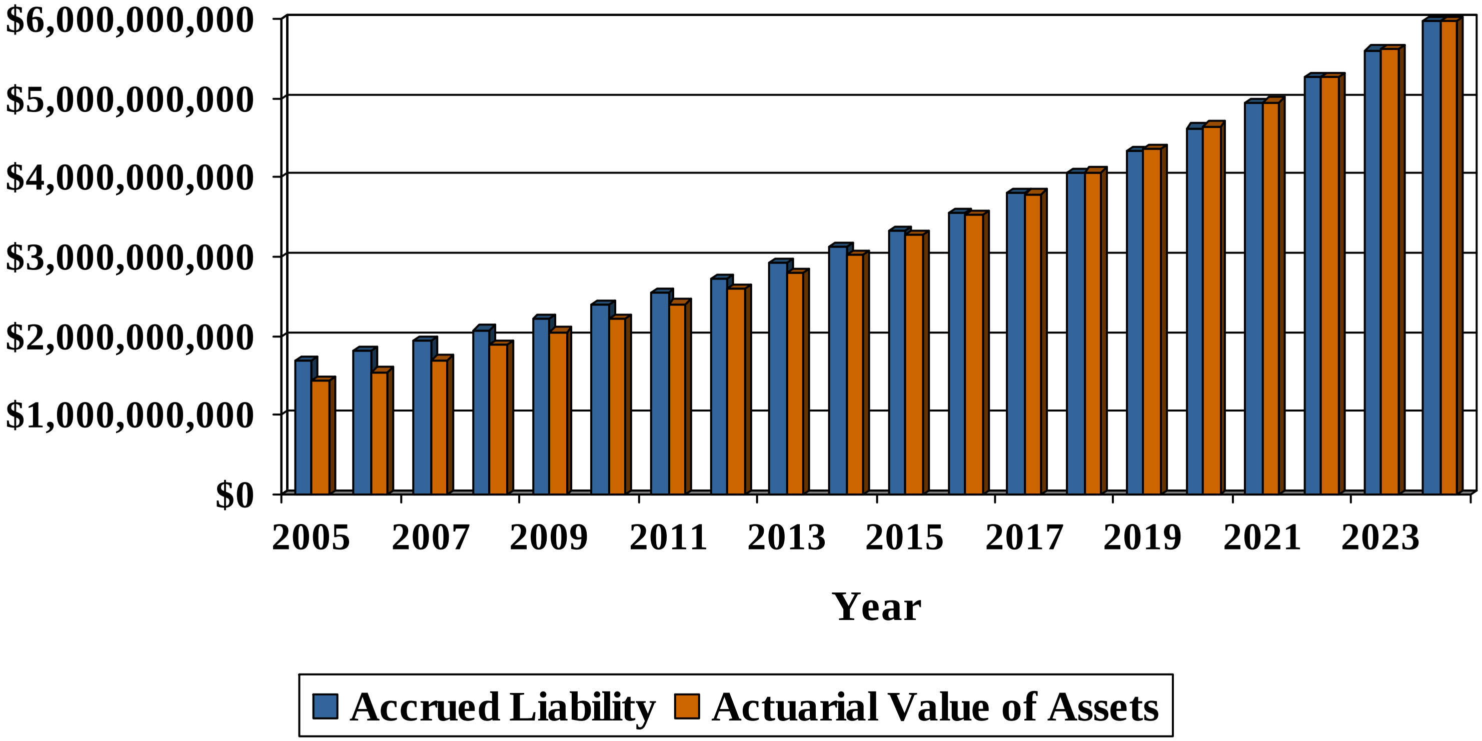


Theoretical Cost Allocation

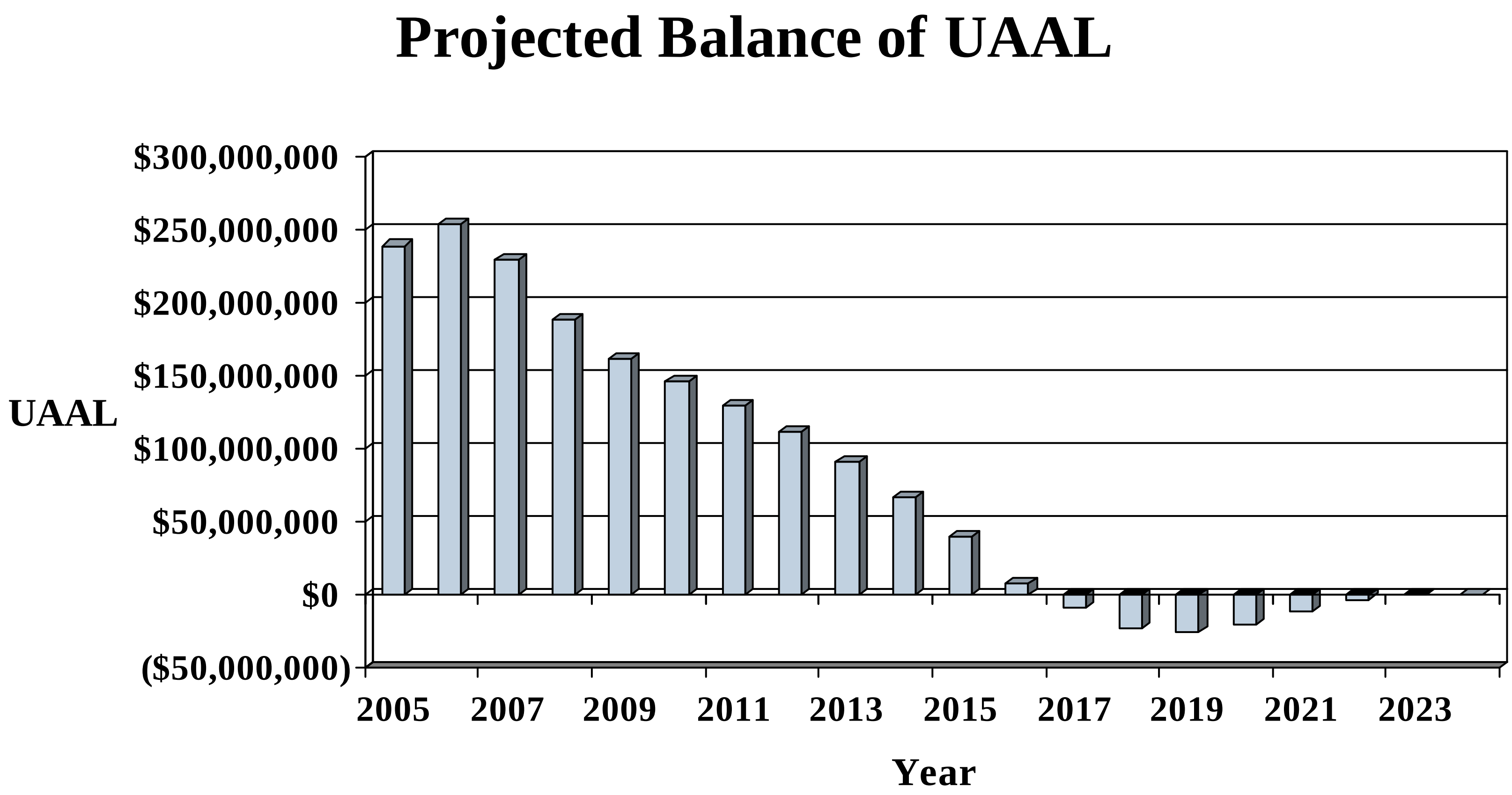
- The **accrued liability** represents the liability attributable to prior service by the cost method.
- The **normal cost** represents the increase in liability attributable to an additional year of service.
- Different actuarial cost methods use different techniques for allocating costs to periods of service.
- The **unfunded actuarial accrued liability** is amortized over 15 years as a level percentage of payroll.

Funding Policy
Projection Assuming All Assumptions are Met (No Excess Earnings)

Projections of Assets and Liabilities



Funding Policy
Projection Assuming All Assumptions are Met (No Excess Earnings)



Funding Policy
Actuarial Methods and Assumptions

- We concur with
  - Use of entry age normal cost method
  - Use of asset smoothing method to mitigate volatility in contribution rates
  - The amortization method
- We are concerned that
  - Use of smoothed assets in communicating funded status to decision makers and stakeholders may inappropriately affect decisions
  - Retiree mortality rates do not reflect anticipated improvement in mortality
  - Inflation assumption is relatively high, and is also used for wage growth

Funding Policy
Summary of Reserves

Type of Reserve	Value at 6/30/2005	Sources of Growth (infrequent in blue)	Sources of Decline (infrequent in blue)	Interest Credit	Underlying Benefit
Member Reserves	$135m	Contributions, interest	Member refunds; transfers for new retirees	8.16%	Member accounts for current and former employees not yet retired
County & District Reserves	$487m	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	Interest; transfers from Stability Reserve (excess earnings)	Transfers to other reserves	8.16%	No underlying benefit
Benefit Enhancement Reserve	0	Interest; transfers from Stability Reserve (excess earnings)	Transfers to other reserves	8.16%	Available to increase the benefits underlying other reserves

Funding Policy
Summary of Reserves

Type of Reserve	Value at 6/30/2005	Sources of Growth (infrequent in blue)	Sources of Decline (infrequent in blue)	Interest Credit	Underlying Benefit
Retired Member Reserve	$679m	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	Interest; transfer for benefit increase (from excess earnings)	Benefit payments	8.16%	Death benefit.
Health Coverage Reserve	$45m	Interest, transfer from Contingency Reserve	Benefit payments	8.16%	Retiree health benefits
Supplemental Health Coverage Reserve	$48m	Interest, transfer from Strategic Reserve (and small amount from Contingency Reserve)	Benefit payments	8.16%	Retiree health benefits
Sick Leave Reserve	$5m	Interest	None	8.16%	Short term disability

Funding Policy
Summary of Reserves

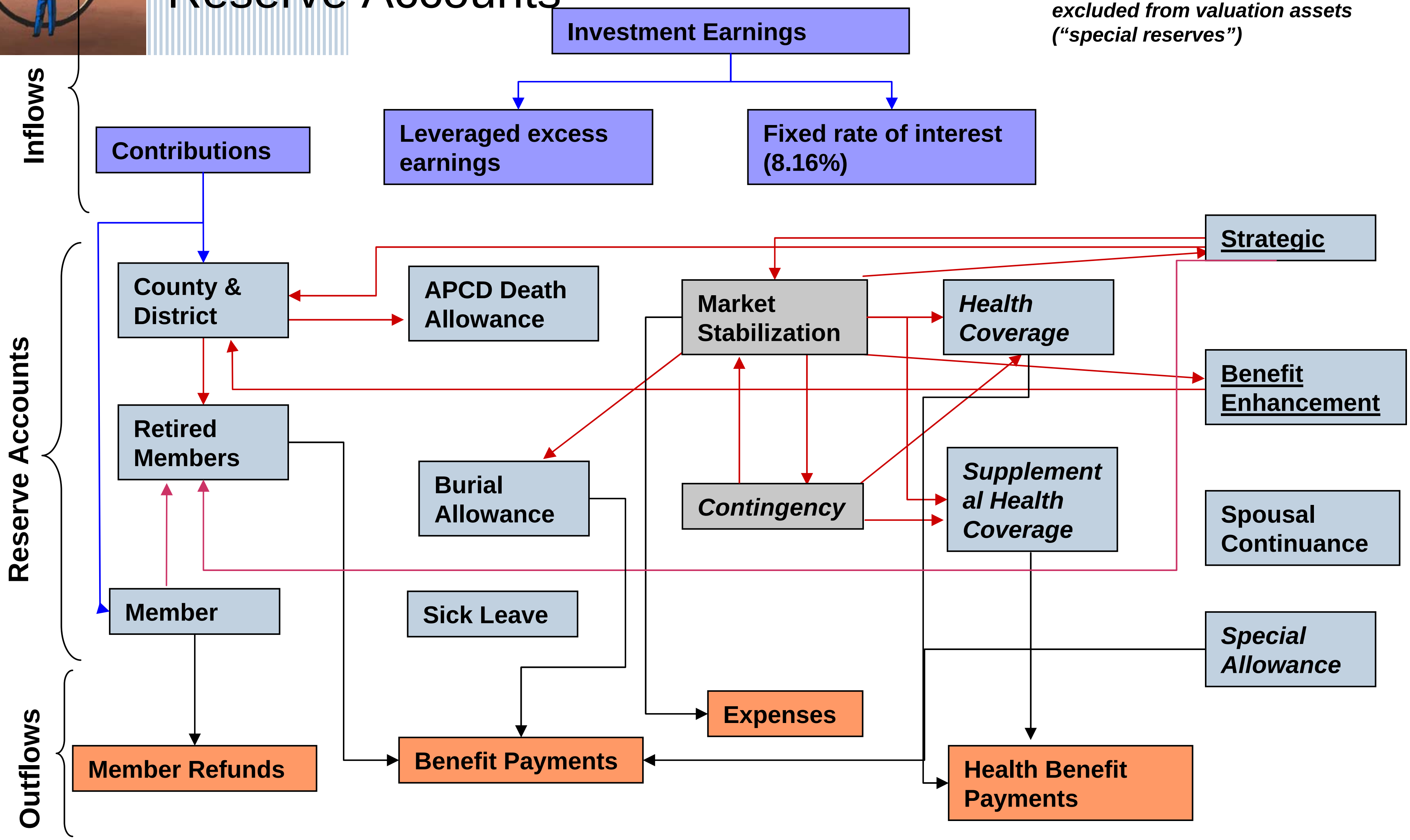
Type of Reserve	Value at 6/30/2005	Sources of Growth (infrequent in blue)	Sources of Decline (infrequent in blue)	Interest Credit	Underlying Benefit
Spousal Continuance Reserve	$2m	Interest	None	8.16%	Special postretirement benefits for surviving spouses
Special Allowance Reserve	$20m	Interest	Benefit payments	8.16%	Purchasing power COLA
APCD Death Allowance Reserve	$39k	Interest, transfers from District & County Reserve	None	8.16%	Death benefit
Contingency Reserve (<> 1-3% of NAV)	$25m	Interest, transfers from excess earnings	Transfers to excess earnings and to health reserves	8.16% in some years	No underlying benefit
Market Stabilization Reserve	$45m	Excess earnings (negative in some years); transfers from Contingency Reserve	Transfers to other reserves	Variable	No underlying benefit

Funding Policy Reserve Accounts

Most reserves receive fixed interest credits at 8.16% each year

Red connectors indicate transfers between reserve accounts

Italics indicate reserves currently excluded from valuation assets ("special reserves")



Underline indicates that reserve currently has a zero balance.

The Contingency Reserve has not received interest since 6/30/2004

Funding Policy
GASB Reporting of Reserves

- All reserves are included as assets, but some reserves are also included as a liability even if no benefit has been defined or approved for the assets in that reserve.
- This practice is not consistent with our understanding of GASB 25 or GASB 43.
- This practice distorts the reported funded status, and as we will note later, may make benefit improvements appear to be free.

Funding Policy
Excess Earnings

- ’37 Act defines Excess Earnings as the earnings remaining after all reserves are credited with the assumed interest (8.16%).
- ’37 Act permits distribution of Excess Earnings for certain purposes if the Excess Earnings represent more than 1% of total assets
- SBCERS technical calculation is consistent with the ’37 Act definition of Excess Earnings
- It is not clear how the uses of Excess Earnings permitted in the ’37 Act are supposed to comply with the Internal Revenue Code
- May jeopardize tax qualification of pension trust

Funding Policy
Excess Earnings

Calculation of Excess Earnings

Figures extracted from reserve spreadsheets

a	**Market Stabilization Reserve**	**6/30/2003**	**(65,498,089)**
b	Realized investment income and gains/(losses)		(35,787,808)
c	Investment Expenses		(3,772,335)
d	Administrative Expenses		(1,985,863)
e	Unrealized investment gains/(losses)		224,882,233
f	Investment Earnings, net of expenses	(b+c+d+e)	183,336,227
g	Interest Credited to other Reserves	(8.16%)	(100,268,723)
h	Excess Earnings during year	(f+g)	83,067,504
i	Transfers in/(out)		(2,161)
j	**Market Stabilization Reserve**	**6/30/2004**	**17,567,254**
k	Realized & Unrealized investment income and gains/(losses)		139,767,675
l	Investment Expenses		(4,396,216)
m	Administrative Expenses		(1,842,161)
n	Investment Earnings, net of expenses	(k+l+m)	133,529,298
o	Interest Credited to other Reserves	(8.16%)	(106,228,990)
p	Excess Earnings during year	(n+o)	27,300,308
q	Transfers in/(out)		0
r	**Market Stabilization Reserve**	**6/30/2005**	**44,867,562**

§31592. Excess interest as reserve against contingencies

Earnings of the retirement fund during any year in excess of the total interest credited to contributions and reserves during such year shall remain in the fund as a reserve against deficiencies in interest earnings in other years, losses on investments and other contingencies, except as provided in Sections 31529.5 and 31592.2

(Amended by Stats. 1977, Ch. 202, Sec. 2.)

§31592.2. Excess interest; disposition

In any county, earnings of the retirement fund during any year in excess of the total interest credited to contributions and reserves during such year shall remain in the fund as a reserve against deficiencies in interest earnings in other years, losses on investments, and other contingencies, except that, when such surplus exceeds 1 percent of the total assets of the retirement system, the board may transfer all, or any part, of such surplus in excess of 1 percent of the said total assets into county advance reserves for the sole purpose of payment of the cost of the benefits described in this chapter.

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.

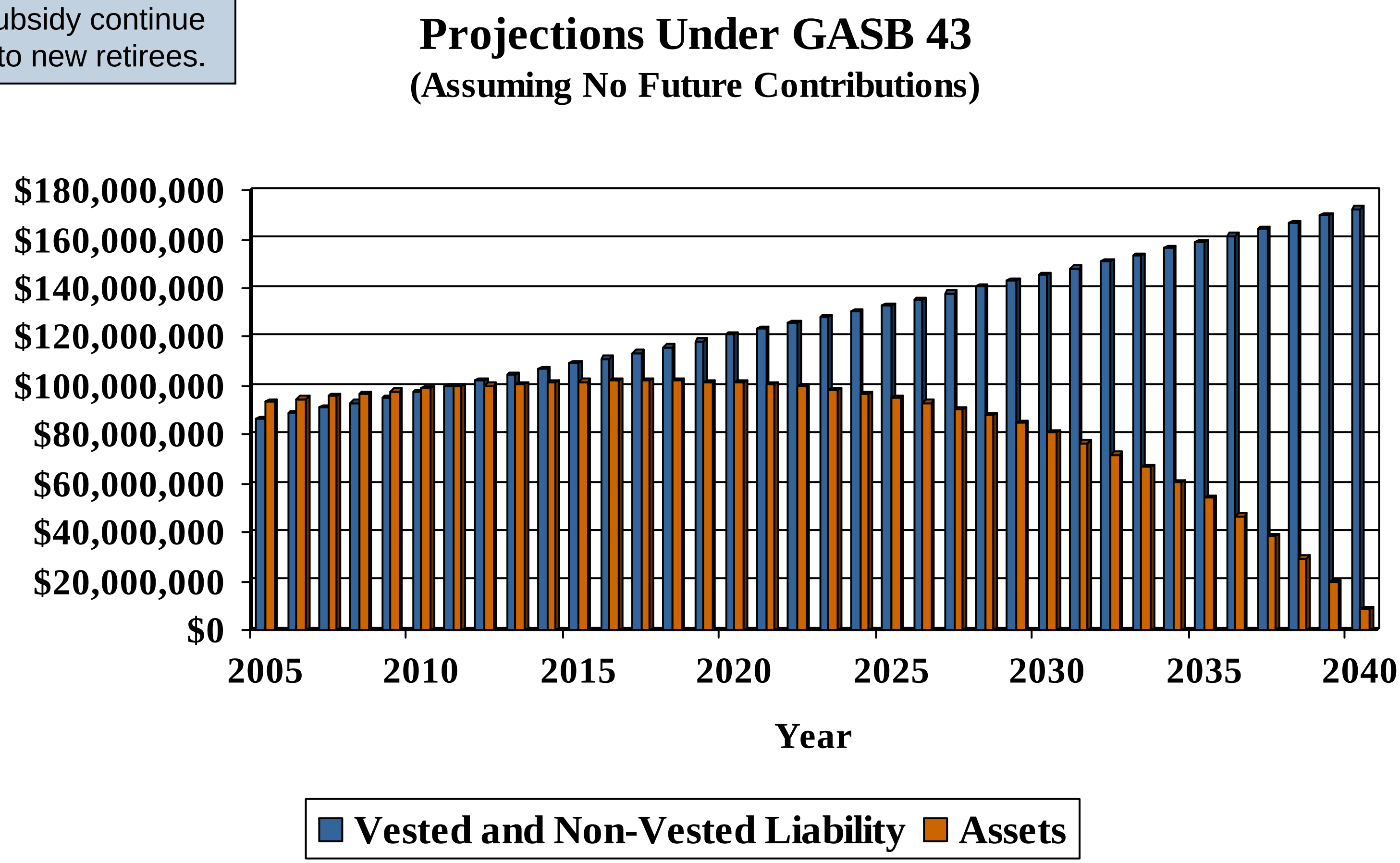
(Amended by Stats. 1980, Ch. 1116, Sec. 1. Effective September 26, 1980.)

Funding Policy
Retiree Healthcare

- Retiree healthcare benefits are currently funded through Excess Earnings and credited with the assumed rate of earnings regardless of actual earnings
- The GASB 43/45 valuation indicates that the retiree healthcare reserves are sufficient to pay all vested and non-vested benefits, but based on our analysis the reserves are not sufficient to pay the current level of benefits indefinitely.
- The fact that vested and non-vested benefits are paid out of the same fund, may create additional liability for the vested benefits.

Funding Policy
Projections from GASB 43 Valuation

The projection assumes the $15 and $4 subsidy continue to be offered to new retirees.



Funding Policy
Retiree Healthcare Funding Structure

- The retiree healthcare reserves are not currently set up as a 401(h) account within the pension plan. Consequently, they should be taxed like a pension benefit, but SBCERS reports them to the IRS as a non-taxable benefit.
- SBCERS is a pension trust that can only pay pension benefits. Payment of retiree medical benefits from a pension trust may violate the “exclusive benefit rule” potentially resulting in the disqualification of the pension trust
- If set up 401(h) account:
  - Must be funded with County contributions
  - Actual earnings must be credited
  - Benefits must be defined (and vested)

Funding Policy
Retiree Healthcare GASB Issues

- Because current retiree healthcare reserves do not receive actual earnings, they may not qualify as assets under GASB 43
- If retiree healthcare benefits are funded with Excess Earnings from a pension plan, GASB has indicated that some of the contributions to the pension plan should instead be attributed to the retiree medical plan
- 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.

Benefit Policy

Benefit Policy
Outline of Pension Benefit Structure

- Benefits based on Final Average Salary, Years of Service, and age based Retirement Factor
  - Final Average Salary based on highest consecutive 12 months
  - Retirement Factor
    - General members - 2% at 57 (Plan 5A and Plans 5B)
    - Public Safety members - 3% at 55
- 5 year vesting of benefits
- Funded by Employer and Employee contributions
- Monthly retirement benefit may begin as early as age 50 with 10 years of service
- 3% annual COLA after retirement
- Purchase of additional service available to participants
- Reciprocity agreements with other public employers
- Death and disability benefits provided

Benefit Policy
Use of Excess Earnings

- '37 Act permits use of Excess Earnings in any year when undesignated reserves exceed 1% of total assets
- Board policy appears to be to distribute Excess Earnings when permitted by the '37 Act
- 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
- The result of the Board policy is that approximately 50% of excess earnings are used to provide additional benefits for retirees. The retiree reserve represents half of the total.

Benefit Policy
Use of Excess Earnings

- Following this policy, the Board would distribute approximately $29 million in additional retiree benefits this year even though SBCERS is not fully funded.
- Depending on future earnings, the Board may distribute virtually no additional Excess Earnings or more distribute a substantial amount
- With a portion of Excess Earnings being used to provide additional benefits and no corresponding reduction in benefits for poor earnings, the risk-return profile is asymmetric.

Average Investment Return	Additional Benefits Granted to Retirees Over 50 Years
9.6%	$3,000,000,000
8.16%	$ 77,000,000
5.8%	$ 0

Benefit Policy
Use of Excess Earnings

- While the ’37 Act permits the distribution of Excess Earnings when they exceed 1% of total assets, this should not be the only criteria used by the Retirement Board in deciding when to distribute Excess Earnings.
- The Retirement Board has a fiduciary duty to protect the existing benefits before granting 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.
- 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.

Benefit Policy
Analysis Used to Grant Benefit Improvements

- For the 2001 benefit improvement, assumptions were from December 31, 1999 actuarial valuation
- No change in assumptions was reflected with the proposed benefit improvements and it appears that no sensitivity analysis was performed
  - No increase to retirement rates were included
    - Some increase expected due to richer benefits
  - Significant increase in actual versus assumed retirement rates after improvements for Safety employees
    - 42 expected retirements from 1/1/2001 to 6/30/2003
    - 74 actual retirement from 1/1/2001 to 6/30/2003
  - Loss experienced due to more retirements than expected

Benefit Policy
Analysis Used to Grant Benefit Improvements

- For the change to a 1-year final average salary, there does not appear to have been any adjustment of assumptions or sensitivity analysis about potential salary spiking that can occur with the shortened averaging period.
- Experience has shown losses related to salary increases for new retirees
- When the decision to improve benefits was made, the analysis used the smoothed value of assets to measure funded status. A more accurate measure is based on market value, and depending on the exact timing of the decision, may have affected the outcome.

Benefit Policy
Analysis Used to Grant Benefit Improvements

- The actuary estimated the value of the additional benefits at approximately $55 million
- The actuary estimated the increase in the UAAL due to the new benefits at approximately $25 million because certain reserves were transferred to fund the benefit improvement and these reserves were already treated as a liability.
- These special reserves were set aside in prior years and credited with the assumed rate of interest even though the market had begun to decline before they were used for the benefit improvements.
- The accounting methodology for these reserves makes benefit improvements appear less costly than they actually are.

Benefit Policy
Retiree Healthcare Benefits – Explicit Subsidy

- Retirees who select coverage under the County of Santa Barbara insurance options receive $15 per month in subsidy from SBCERS
- Retirees who select coverage under a plan not sponsored by the County of Santa Barbara receive $4 per month in subsidy from SBCERS
- In accordance with a legal settlement, benefits were set at $8 and $1.47 per month per year of service for retirees as of 6/24/88 although in practice the benefits have been granted to all retirees
- Retirement Board has used Excess Earnings to increase benefits since then. By definition, these increases are not vested.

Benefit Policy
Retiree Healthcare Benefits – GASB

- 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.

Benefit Policy
Retiree Healthcare Benefits – 401(h) Account

- Creating a 401(h) account for the retiree healthcare benefits would allow the benefits to be tax exempt for the retirees.
- The current proposal would vest retirees in the full $15 and $4 per month.
- The current proposal's exchange of County contributions to a 401(h) account for distribution of Excess Earnings to the pension plan (and treatment as a contribution to the pension plan) raises some issues:
  - Would IRS view the exchange as circumventing the "exclusive benefit rule?"
  - GASB would not treat the transfer of Excess Earnings as a contribution, so the full ARC would not have been contributed.

Benefit Policy
Retiree Healthcare Benefits – 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.

	Prem	Pmts per Year	Annual Prem	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%

Benefit Policy
Retiree Healthcare Benefits – PPA

- 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 1/1/2007. County and SBCERS may want to research to determine if appropriate for County safety members.

Investment Policy

Investment Policy
Asset Allocation

- The asset allocation described in the investment policy determines the expected return for the portfolio and the expected volatility
- A higher expected rate of return reduces costs for members and the County
- Higher volatility increases the likelihood of excess earnings, resulting in potentially higher benefits for members
- Higher volatility also increases the likelihood of poor earnings, resulting in potentially higher costs for the County

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%**

Investment Policy
Expected Return and Volatility

Percentiles	Projection Horizon (years) 1	5	10	20
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%

- Using Mercer Investment Consulting's capital market assumptions as of 1/1/2006, 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

Investment Policy
Comments

- 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.

Historical Review of Funded Status

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 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**

History of Funded Status

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

- 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.
- Based on market value, there was actually a $391 million change in UAAL during this period, including a $464 million drop between 12/31/1999 and 12/31/2002.
- 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.

History of Funded Status

- In addition, the actuary's reconciliation:
  - 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 12/31/2000 appear to only increase the UAAL by $25 million when the actual cost was nearly $55 million using the actuary's estimates.
  - Does not include some benefit increases (e.g., ad hoc retiree colas), presumably because they were funded from special reserves that were already considered a liability.
  - Does not address whether or not some portion of the $75.6 million in demographic losses may be attributable to the benefit improvements.
- The conclusion that the primary cause of the unfunded liability during this period is poor investment returns is still accurate.

Summary and Recommendations

Summary and Recommendations

- We identified a number of concerns summarized on the following slides
  - While our focus has been on the areas of concern, we do not intend to imply that the system is in a crisis
  - Our intent is to raise issues so the County can better understand and manage the retirement system
- SBCERS is reasonably well funded and uses sound underlying methodologies

Summary and Recommendations
Concerns Identified

- 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.

Summary and Recommendations
Concerns Identified

- 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.

Summary and Recommendations
Concerns Identified

- 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.

Summary and Recommendations
Recommended Approach

- We recommend that the County work with the Retirement Board to take appropriate corrective action or to investigate alternatives and develop appropriate policies.
- We recommend the following overriding objectives be adopted for this work:
  – Confirm compliance with applicable laws and regulations
  – Improve the stability of the retirement system
  – Improve the transparency of the retirement system