BOARD OF SUPERVISORS AGENDA LETTER

Agenda Number:

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

Department Name:	CEO & Auditor-Controller
Department No.:	012 & 061
For Agenda Of:	October 18, 2016
Placement:	Departmental
Estimated Time:	30 Minutes
Continued Item:	No
If Yes, date from:	
Vote Required:	Majority

TO: Board of Supervisors

FROM: Department Director(s) Mona Miyasato, County Executive Officer, x3400
Theodore Fallati, Auditor-Controller, x2100
Contact Info: Tom Alvarez, Budget Director, x3400

SUBJECT: **Request that SBCERS phase-in investment rate of return assumption changes**

County Counsel Concurrence
As to form: Yes

Auditor-Controller Concurrence
As to form: Yes

Recommended Actions:

That the Board of Supervisors:

a) Authorize the County Executive Officer (CEO) to sign and submit a letter (Attachment A) to the Board of Retirement of the Santa Barbara County Employees' Retirement System (SBCERS), before it adopts the pension contribution rates for next fiscal year, requesting that it consider the following changes to allow a gradual increase in anticipated pension costs:

  i. A reduction to the assumed investment rate of return (ROR) on plan assets in FY 2017-18 be no more than a 25 basis point reduction (from the current 7.5% to 7.25%); and

  ii. Any additional reductions also be limited to 25 basis points (i.e., from 7.25% to 7%) per year and be implemented in FY 2020-21 after the next experience study is performed; this would bring the ROR from 7.5% to 7.0% in 4 years;

b) Request that the Board of Retirement delay any decision on assumption changes until County staff has adequate time (approximately one month) to review the actuarial assumptions and impacts of such changes; or

c) Direct other action as appropriate; and

d) Determine that the above actions are not a project under the California Environmental Quality Act (CEQA), pursuant to CEQA Guidelines Section 15378(b)(4), as government funding mechanisms which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment.

Summary Text:

At its October 26, 2016 meeting, the Board of Retirement of the Santa Barbara County Employees' Retirement System (SBCERS) will receive an actuarial report (based on a three-year experience study) and consider changes to its actuarial assumptions and the investment rate of return (ROR) on plan assets (now at 7.5%). It is anticipated that the County's pension costs will rise in FY 2017-18 as a result of these changes and below target investment returns of 1.4% for fiscal year ending June 30, 2016. While final adoption of pension contribution rates would not occur until the SBCERS' December meeting, the assumptions that affect these rates are expected to be approved at the SBCERS' October meeting.

Staff is therefore requesting that, prior to the SBCERS Board taking action on the assumptions and assumed ROR, it allow the County adequate time (approximately one month) to review the actuarial report and impacts of such actuarial assumption changes. The actuarial study is expected to be released just prior to October 26.

Staff is also requesting that, should the SBCERS Board make changes to certain actuarial assumptions, these changes be implemented over a period of time rather than all at once to allow the County an ability to manage and plan for the increased costs, which are estimated to range from $30 million to $43.1 million over 5 years.

SBCERS has taken proactive steps in the recent past, such as instituting a 17-year, closed amortization period for the unfunded pension liability (compared to longer or rolling periods in other systems), smoothing in losses over five years and gradually reducing the ROR. Staff acknowledges that the investment landscape has changed over the past decade, and reducing the assumed ROR on plan assets should be considered; however, these are long term commitments and investments that should be gradually adjusted for current trends. Staff therefore recommends that the ROR be adjusted in a gradual manner over time to lessen the negative impact on County services and residents.

Possible Scenarios and Estimated Impacts

While the amount of possible increase is unknown until the SBCERS actuary (Cheiron) has completed and presented its work to the SBCERS Board on October 26, 2016, County staff has developed estimates given previous information obtained from Cheiron. These estimates are based on the following:

- A 25 basis point reduction in the assumed ROR will equate to an approximate 4% increase in the County's contribution rate (the increase is smoothed in over 5 years).
- The recent investment loss for the period ending 6/30/2016 will result in an estimated 5% increase to the County's contribution rate (increase smoothed in over 5 years).
- Elements such as mortality, employee mix (PEPRA vs. legacy) and inflation are factors that impact the pension rates. Because this information will not be available until just prior to the October 26th meeting, the estimates presented here do not consider these impacts.

The scenarios also assume that the targeted rates of return on invested assets are achieved in FY 2016-17 and subsequent years. Deviations from the assumed ROR would improve or worsen the estimated results. It should be noted that the increases in contribution rates will continue until they are fully amortized (approximately 20 years).

- **Scenario #1**: A 25-basis point reduction in ROR (7.5% to 7.25%) in FY 2017-18 could result in an increase in pension contribution from the current blended rate of 36.6% of pensionable payroll to 45% of pensionable payroll, or an increase of approximately $30 million countywide over 5 years.

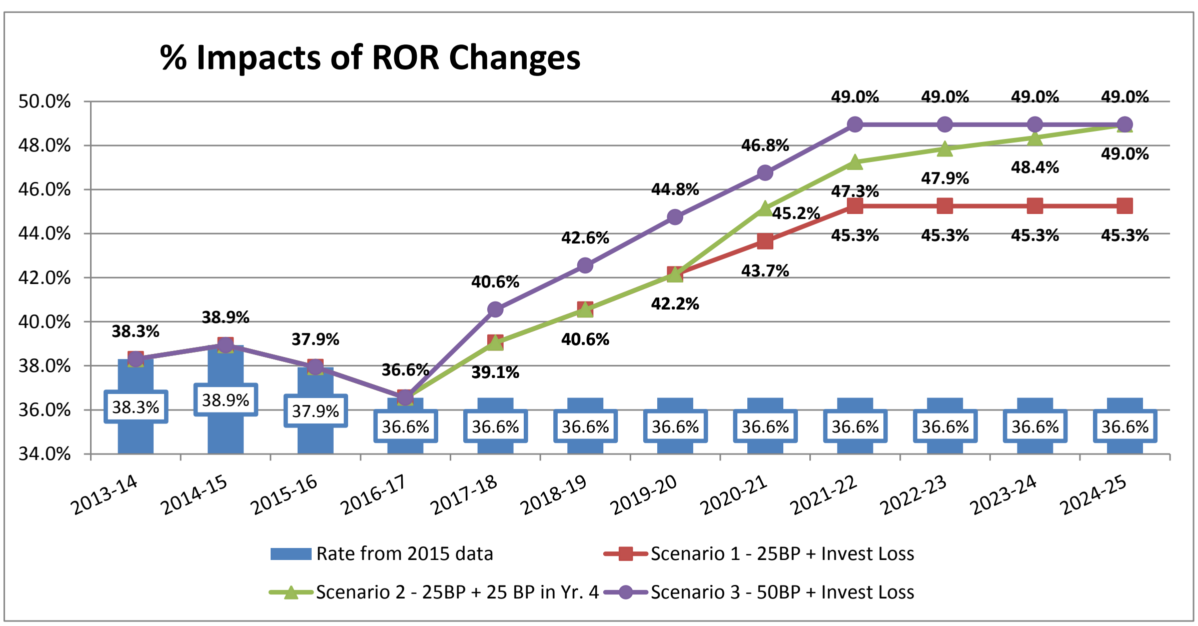
- **Scenario #2**: A 25-basis point reduction in ROR (7.5%to 7.25%) in FY 2017-18, followed by another 25 basis point reduction in FY 2020-21 (7.25% to 7.0%), could increase the pension contribution from the current blended rate of 36.6% of pensionable payroll to 47% of pensionable payroll, or an increase of approximately $37.2 million countywide over 5 years.
- **Scenario #3**: A 50-basis point reduction in the ROR (from 7.5% to 7.0%) in FY 2017-18 could result in an increase in pension contribution from the current blended rate of 36.6% of pensionable payroll to 49% of pensionable payroll, or an increase of approximately $43.1 million countywide over 5 years.

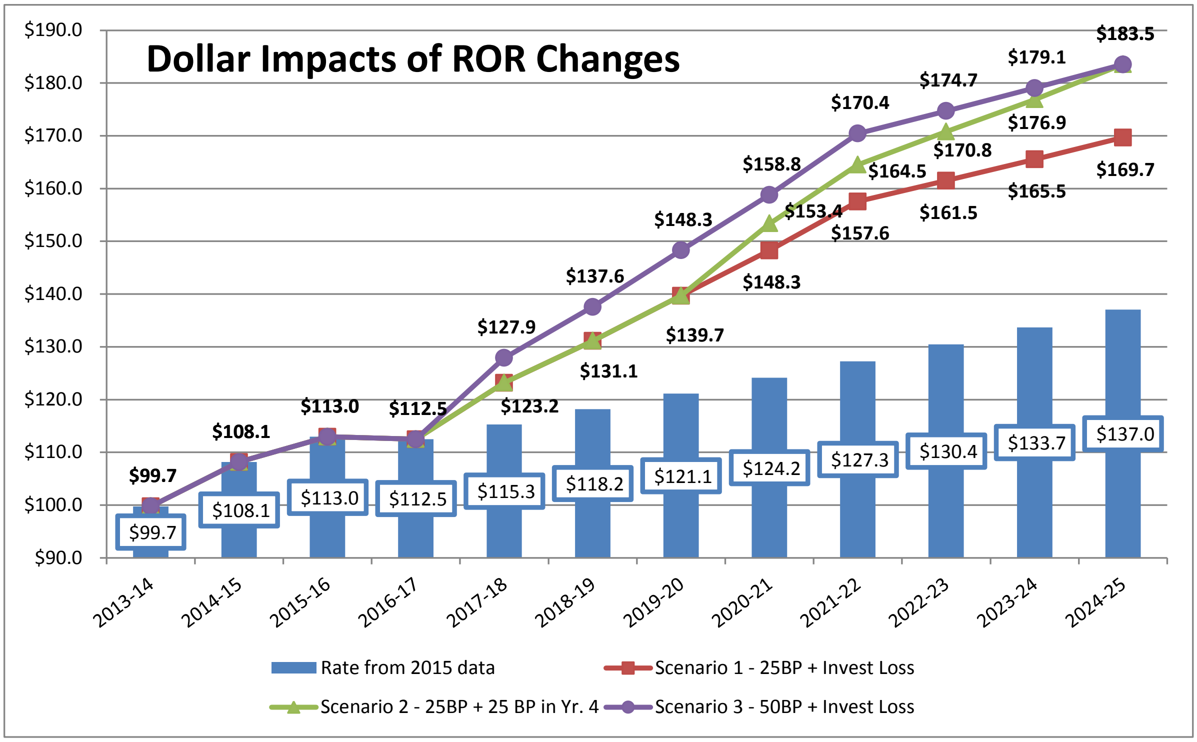
Staff also evaluated a 50-basis point reduction in ROR (from 7.5% to 7.0%) over five years, with five, annual 10 basis point reductions beginning in FY 2017-18. However, the results were fairly similar to Scenario 2. Based on these similar results we are not showing or recommending the 10 basis points per year option.

Scenarios #1 and #2 are preferable to Scenario 3. Even with smoothing in of investment losses, a more gradual approach is still requested to phase in these higher costs. The County had planned for some pension increase in FY 2017-18, but the unplanned investment losses combined with a 50-basis point reduction in ROR would result in cost increases of $12.6 million in FY 2017-18, growing to $43.1 million in FY 2021-22, which would exceed anticipated available funding and would negatively impact County services and residents.

The charts below show all three scenarios. The first chart shows the scenarios' estimated impacts on contribution rates (percentages of pensionable payroll); the second chart shows the impact by estimated dollars.

- The result of Scenario #1 is an 8.7% increase in the contribution rate from 36.6% of pensionable payroll to a 45.3% of pensionable payroll over the coming 5 years.
- The results of Scenario #2 is an increase from 36.6% to 49% of pensionable payroll, which is phased in over 8 years.
- The result of Scenario #3 is the same as #2 (increase from 36.6% of payroll to 49%) but occurs more quickly, over 5 years.
- Scenarios #2 and #3 can be compared to the 15.6% increase experienced after the Great Recession (2008 – 2013) when pension contributions increased from 23.3% of payroll to 38.9% of payroll.





As can be seen above, the impact of Scenario #1 is less than #2 and #3. Scenario #2 and #3 will ultimately result in the same dollar contribution but Scenario #2 (green line) will be phased in over a longer period of time.

Background:

Current and Past Pension Contribution Rates

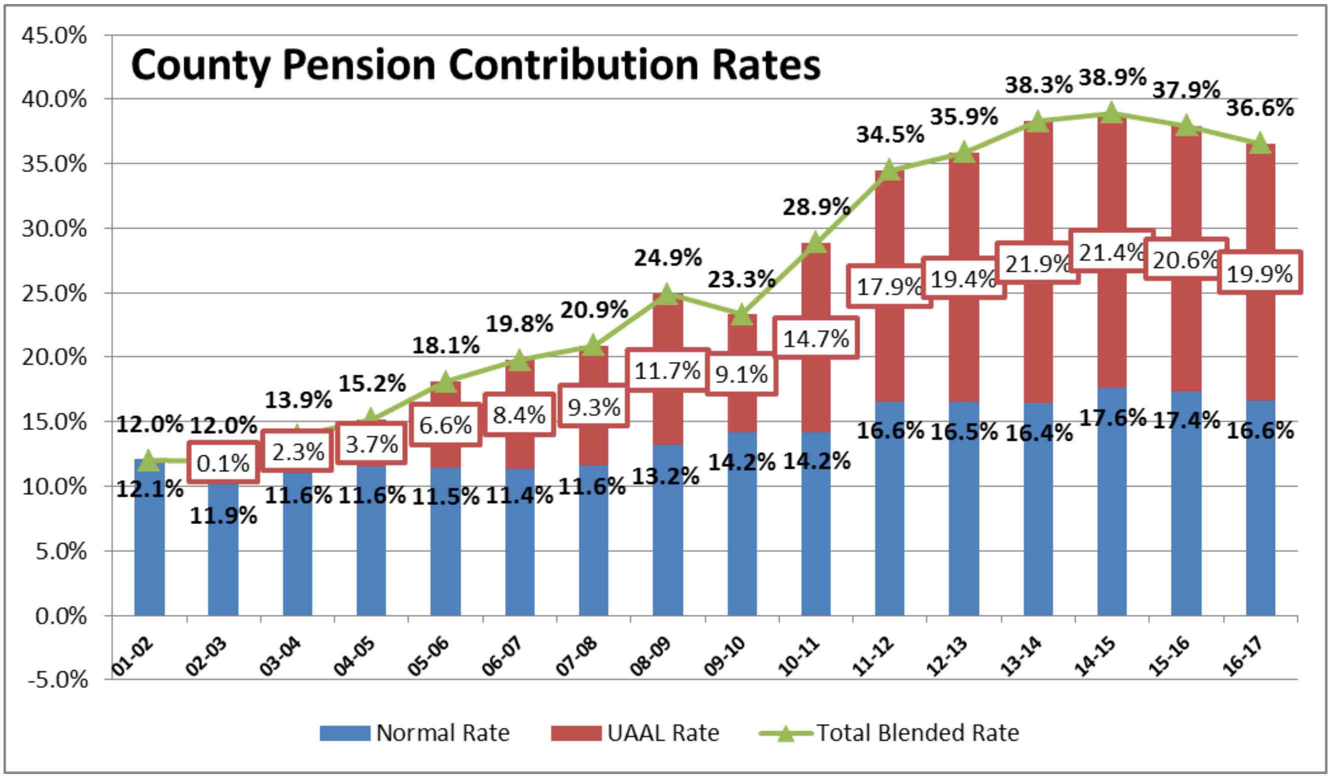
State law provides that the Board of Retirement of SBCERS has exclusive control of the investments by, and administration of, the County's pension system. The County of Santa Barbara is a plan sponsor but does not make decisions as to the fund's investments or the actuarial assumptions that determine the required contributions necessary to fund existing and future employee pension benefits.

Pensions are one of the largest costs faced by local government. The County's pension contribution for FY 2015-16 was $112.5 million and the unfunded liability was $675.3 million (measured as of June 30, 2015). The SBCERS Board implemented a plan 3 years ago to amortize the unfunded liabilities over a 17 year period of time.

During the past 16 years, the County has seen its blended contribution to pension costs increase from 12% of pensionable earnings to a peak of 38.9% in FY 2012-13. In dollar terms, this reflected an increase from $27.2 million in FY 1999-2000 to $112.5 million in FY 2015-16. These increases reflect enhancements to benefits in the early 2000's, investment losses after the tech bubble in 2000 and the effects of the great recession in 2008.

After years of significant increases, last fiscal year was the first time during this period where the dollar contribution actually went down, a result in part to pension reform implemented by the County in 2012 (Plan 7, which created a lower-cost benefit formula for new employees) followed by the State Public Employee Pension Reform Act, or PEPRA, which did the same.

The graph below demonstrates the change in the pension contribution percentage over time. The blue bar indicates that the normal contribution rate has grown from 12.1% to 16.6% of payroll; however the unfunded actuarial liability (UAL, red line) has increased from 0% to 19.9%. The combination of these equals the total County pension contribution rate shown in green.



Note: *Above dates reflect the County's fiscal year's rates which are developed using prior actual data. Example: The FY 2016-17 contribution rates were based on June 30, 2015 data.*

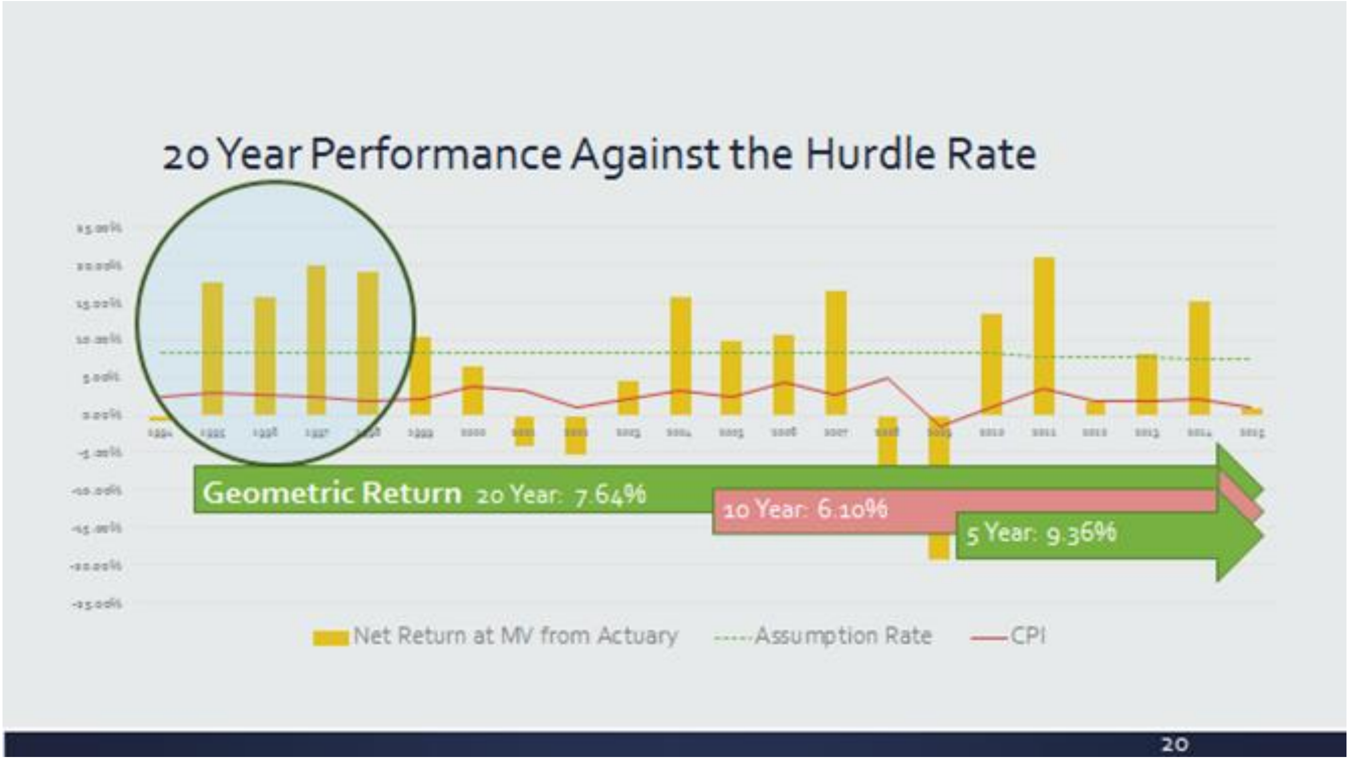
Potential Impact of Recent Investment Losses

Rates had stabilized in FY 2014-15 but the SBCERS actual return on invested assets in the past two years (0.8% and 1.4%) were significantly below the target rate of 7.5%. This results in a lower amount of funds available for future benefits and creates a need for higher employer contributions.

To illustrate the impact on invested funds of $2.5 billion, note the target vs. actual performance:

- 7.5% return = $187.5 million (target)
- 1.4% return = $35.0 million (actual for 6/30/15)
- Difference = $152.5 million

In the above illustration, the County is responsible for the funding shortfall created by the lower rate of return. Over time, the actual rate of return is expected to average out, having both gains and losses when compared to the assumed rate of return. The actual historic rates of return are summarized below (source: SBCERS at a March 2016 presentation; excludes the most recent June 2016 result of 1.4%):



Fiscal and Facilities Impacts:

Budgeted: No.

Narrative: Fiscal analyses of these changes are presented in the Board Letter.

Authored by:

Tom Alvarez, Budget Director

John Jayasinghe, Fiscal and Policy Analyst

Attachments:

Letter to Board of Retirement from CEO