

County of Santa Barbara
Office of the Auditor–Controller
County Retirement Costs: White Paper by Robert W. Geis, CPA
(Through June, 30, 2006)

The County Retirement plan and underlying systems can be difficult to understand due to the complexities of the benefit, investment and funding policies. The benefit system is a multi-employer plan that includes the County, Courts, Air Pollution Control, Santa Barbara Association of Governments and six Special Districts. There are nine different benefit plans. The funding policy is driven by a complex array of actuarial science, federal tax laws, state legislative code and governmental accounting policies. Losses on investment returns of \$464 million between December 31, 1999 and December 31, 2002 had a dominant impact on the fund. This white paper explains some actuarial and accounting concepts to help the reader better understand the financial condition and dynamics of the pension fund as they relate to the current funded status of the system.

For an in-depth analysis, the County hired an independent third party (Kroll/Mercer) who issued an evaluation of the system dated November 7, 2006 (<http://www.countyofsb.org/auditor/home.asp>). They identified a number of concerns that should be addressed regarding retiree health benefits, the policy of using “excess earnings,” improving the methods to measure the cost of proposed new benefits, making the system more transparent (it is difficult to understand), confirm compliance with applicable laws and improve the stability of the system. To address these concerns, the County hired tax attorneys Ice Miller to guide us towards assuring the Retirement Plan is in compliance with IRS federal tax laws. The County and Retirement system are currently compiling a legal plan document to aid in this effort.

The County has also established a working team to address issues. We are trying to inform and train the BOS and BOR of the fiscal implications of the fund and its practices. We believe the BOS and BOR should establish a funding agreement that addresses the basic pension plan, retiree health and benefit improvements to improve long-term stability. Finally, the County and BOR are addressing and incorporating GASB 43 and GASB 45 implementation requirements for reporting Other Post Employment Benefits (OPEB).

Submitted by:
Robert W. Geis, CPA
Auditor–Controller
(805) 568–2101

Financial Status of Retirement Fund

The County's retirement fund is in good overall financial condition, but maintaining this level is a stress on the County budget. At 6/30/2006 the fund was 86% funded using the actuarial value method of measuring the plan assets available to pay for current and future retirement liabilities, and 90% funded using the market value method. In addition, the County has no outstanding pension obligation bonds. We believe that to be considered in excellent financial condition, the fund should ideally maintain a funded ratio of 125% or more for a consistent period of time. Superior earnings above the system-expected investment earnings rate of 8% would contribute to this excellent overall funding status.

The following two tables demonstrate the financial status of the plan over the last seven years. They will also be used to show the volatility of investment returns within the system that can occur within an economic cycle. It is important that retirement systems and decision makers look at longer planning cycles. Benefits can accumulate over 30 years or longer while an employee works and be paid out for periods over 30 years after they retire.

Asset Smoothing: Under current retirement board policy the Actuarial Value of assets is a smoothed market value in which unexpected investment returns (gains or losses) are recognized over a 5-year period. The purpose is to smooth out the impact of volatile investment returns with respect to County contribution rates. The downside of using the actuarial method is a distortion of when the investment losses were actually incurred.

Actuarial Value (Market Gains/Losses Smoothed over 5-Years to Delay or Soften Impact to Contribution Rates)

(in millions)	12/31/99	12/31/00	12/31/02	06/30/03	06/30/04	06/30/05	06/30/06
Plan Assets	1,068	1,171	1,296	1,347	1,379	1,444	1,553
Accrued Liability (Cost)	1,067	1,145	1,364	1,455	1,579	1,688	1,810
Percent Funded	100%	102%	95%	93%	87%	86%	86%
Over(Under) Funded Amount	1	26	(68)	(108)	(200)	(244)	(257)

No Asset Smoothing: The Market Value of assets is the true picture.

Market Value (No Smoothing)

(in millions)	12/31/99	12/31/00	12/31/02	06/30/03	06/30/04	06/30/05	06/30/06
Plan Assets	1,247	1,183	1,080	1,169	1,347	1,476	1,629
Accrued Liability (Cost)	1,067	1,145	1,364	1,455	1,579	1,688	1,810
Percent Funded	117%	103%	79%	80%	85%	87%	90%
Over(Under) Funded Amount	180	38	(284)	(286)	(232)	(212)	(181)

Case in point: In 1999 the County was 100% funded per the actuarial value method and 117% funded (\$180 million surplus) per the market value method. In our opinion, this was just short of excellent. At that point decision makers decided to improve both active member and retired member benefits using surplus earnings to pay the benefits (a part of the \$180 million surplus). The cost of these benefits created new liabilities for past service estimated by the actuaries to cost \$87 million. During the implementation of the new benefits the market lost \$142 million by 12/31/00. Therefore, the surplus to pay the benefits was wiped out and new liabilities were created that had not been paid for

over time. The next year the fund lost an additional \$322 million. The market value unfunded liability went from a surplus of \$180 million to a deficit of \$284 million. As discussed later, the plan sponsors (County) are required to payoff the deficit through increases in contribution rates (see UAAL in table below). The point is that even with 117% funding, because of market volatility any change in benefits has to be carefully planned, especially in the area of using surplus earnings to fund benefit increases. A better fiscal policy would be to build a reserve to the 125% or greater funding level with the surplus maintained to guard against market downturns.

County Retirement Contribution Rates, Pensionable Salaries & Basic Cost

The County's cost for the basic pension benefit is represented by contribution rates, which have been growing significantly over the last several years. The table below shows blended rates for all plans. Each separate plan (i.e., General and Safety) has its own rate. For example, in FY 2005/06, the General Plan rates averaged 17%, while the Safety Plan rates averaged 32%. In addition to the Retirement System rate, the County also must pay Social Security of 6.2% for General members. County rates are developed to pay for the annual normal cost of basic pension benefits and to pay for the unfunded liability over 15 years. Over time, the County has also bargained to pick-up a portion of the required employee contribution.

History of Blended Rates

	12/31/99	12/31/00	12/31/02	06/30/03	06/30/04	06/30/05	06/30/06
Normal Cost	12.09%	11.87%	11.63%	11.56%	11.48%	11.38%	11.61%
UAAL	-0.09%	0.08%	2.29%	3.65%	6.63%	8.40%	9.29%
Total Blended Rate	12.00%	11.95%	13.92%	15.21%	18.11%	19.78%	20.90%

History of Pensionable Salaries and Basic Pension Cost

(in thousands)	FY 00/01	FY 01/02	FY 02/03	FY 03/04	FY 04/05	FY 05/06	Estimated FY 06/07	To be used in FY 07/08
Pensionable Salaries	197,458	215,715	227,431	238,879	243,379	250,133	264,732	
x County Blended Rate	12.00%	11.95%	11.95%	13.92%	15.21%	18.11%	19.78%	
= County Basic Pension Cost	23,695	25,778	27,178	33,252	37,018	45,299	52,364	

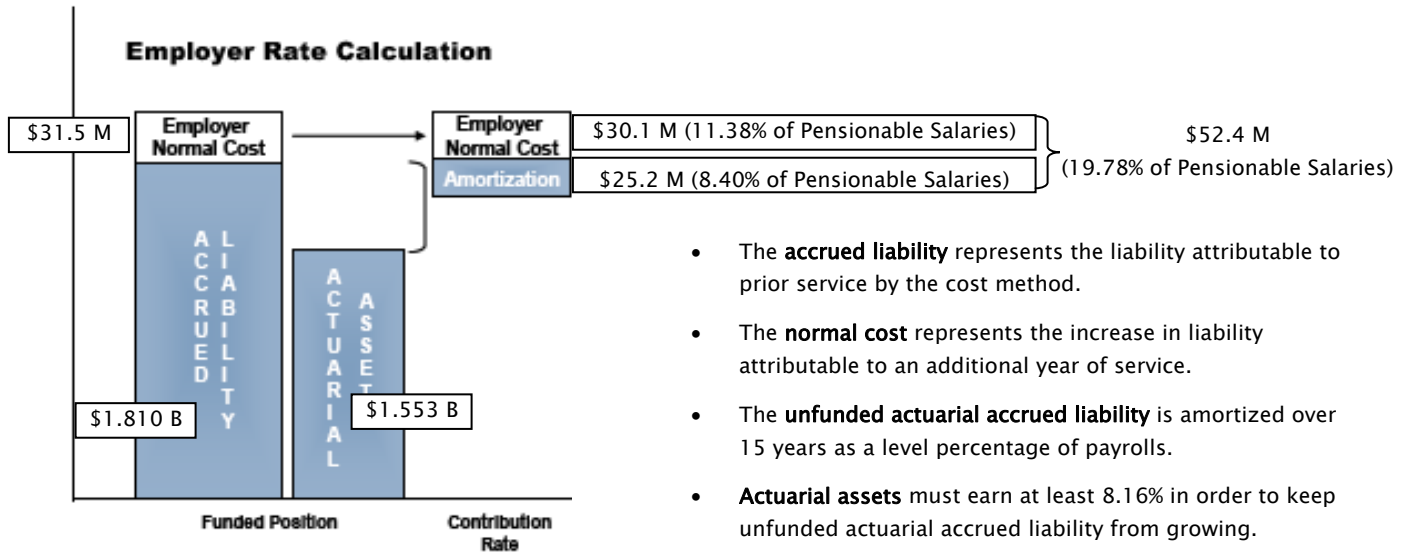
Without actuarial smoothing County contributions rates would have doubled to about 22% in one year starting FY 02-03 and doubling the employer contributions from \$31 million to \$60 million. With the smoothing method, five years later in FY 06-07 contribution rates have now hit 21% with contributions approaching \$57 million.

History of Basic Pension, Employee Pick-up & FICA (Social Security) Cost

(in thousands)	FY 00/01	FY 01/02	FY 02/03	FY 03/04	FY 04/05	FY 05/06	Estimated FY 06/07
County Pension Cost	23,695	25,778	27,178	33,252	37,018	45,299	52,364
Employee Contribution Pick-up	3,418	3,591	4,013	4,208	4,176	4,230	4,300
FICA (Social Security)	8,553	9,349	9,639	9,835	10,001	10,234	11,025
Total Basic Pension	35,666	38,718	40,830	47,295	51,195	59,763	67,689

With FICA (Social Security), the County paid almost \$68 million for basic retirement in FY 2005/06. Almost 10% of the County total budget and 23% of basic salary costs.

Funding Retirement Benefits



This is a pictorial representation of the theoretical overview of retirement funding. Assets must earn 8.16% over the long-term to keep the unfunded actuarial accrued liability (see amortization above) from growing. A lower return due to underperforming investments will cause the unfunded liability to grow. The investment return is the single most important component of the long-term stability of a pension fund.

Funding Retiree Health and Other Benefit Costs

Currently, retirees receive health and other benefits outside of the basic pension benefit. These other benefits are not officially or explicitly paid for through the normal method described above. The method used to pay for these other benefits is a complicated process that takes a portion (50%) of the investment earnings above the expected rate of return ("excess earnings") and sets it aside for these other benefits. This is not an actuarially sound practice because "excess earnings" are not equivalent to surplus earnings. Effectively, this practice diverts assets from the basic pension and increases the unfunded liability. The table below shows the fiscal impact of this practice on the unfunded liability.

With the current practice, the unfunded liability is \$257 million. If the practice was not followed, all assets would be available for the basic pension benefit and there is no additional liability outside of the basic pension benefit, the unfunded liability would be reduced by \$138 million to \$119 million. Each time there is a distribution of "excess earnings," the unfunded liability will increase. For example, at 6/30/06, "excess earnings" totaled \$86 million. If these are distributed, 50% or \$43 million will go towards increasing the retiree health or other benefits and the unfunded liability will increase by \$43 million to \$300 million. The associated County UAAL rate will then increase from 9.29% to 11.31% to pay for the increase in the unfunded liability increasing County costs by an additional \$5 million annually. In addition, the plan sponsor does not contribute the additional cost of the retiree health benefit on an annual basis creating additional unfunded liabilities.

(in millions – based on FYE 6/30/06)	Current Practice	Without Current Practice	Impact of "Excess" Distribution
Assets Available – Basic Pension Benefits	1,415	1,553	1,372
Assets Available – Other Retiree Benefits	138	–	181
Total Assets Available	1,553	1,553	1,553
Liability (future cost) – Basic Pension Benefits	1,672	1,672	1,672
Liability (future cost) – Other Retiree Benefits	138	–	181
Total Liability	1,810	1,672	1,853
Difference (Assets less Costs = "Unfunded Liability")	(257)	(119)	(300)

History of Costs for Retiree Health & Other Benefits

(in thousands)	FY 99/00	FY 00/01	FY 01/02	FY 02/03	FY 03/04	FY 04/05	FY 05/06	Estimated FY 06/07
Retiree Health Costs	3,272	3,676	3,876	4,834	5,202	5,740	6,005	6,250
Cash In-Lieu of Health	273	284	350	520	549	435	449	450
Ad Hoc COLA Costs	2,333	2,321	3,397	2,382	2,334	2,304	2,256	2,300
Total Other Benefits	5,878	6,281	7,623	7,736	8,085	8,479	8,710	9,000

The costs of these external benefits have grown 48% from FY 1999/00 to FY 2005/06. The Mercer/Kroll report states that "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," which is two times our current assets of \$1.553 billion available for basic pension benefits. The nature of these benefit increases is unsustainable by the plan sponsor.

Conclusion

Decision makers should be concerned with the complexities of the benefit, investment and funding policies. What follows are a few concerns:

The system has a 50% chance that it will earn more than 8.16% over the long-term and a 50% chance that it will not earn 8.16%. The volatility of investment returns should always be the first thing considered in any system decision.

The County budget is under stress from the requirement to increase contributions. Actuarial smoothing helps with contribution rates but increases long-term costs. Each decision maker on the Board of Supervisors and Retirement Board should strive to eliminate the UAAL. The goal should be to pay only the next year's normal cost and all normal costs should be paid annually.

The retirement trustees are contemplating continuing the practice of distributing "excess earnings" for new retiree health benefits. It may be argued that it is not prudent to do so if the pension benefits are not fully funded and perhaps more than fully funded.

The County is not funding the additional annual cost of retiree health benefits on an annual basis.

To be competitive with other public safety agencies the County granted the 3% at 50 benefit for public safety members (Sheriff). This cost is not yet reflected in the normal rate or the UAAL rate currently being paid by the County.

The need to provide competitive benefits for general members both for benefit formula and employee contributions continues to be an issue. The County needs to carefully consider and understand the costs associated with any change in benefits.