

April 6, 2005

Mr. Oscar Peters
Retirement Administrator
Santa Barbara County
Employees' Retirement System
3916 State Street, Suite 210
Santa Barbara, CA 93105

Re: Implications of the Defined Contribution Proposal on SBCERS

Dear Oscar:

As requested, we have prepared calculations showing the estimated long-term impact on Santa Barbara County and SBCERS if the recently proposed defined contribution (DC) plan is implemented. Specifically, the DC proposal would close SBCERS to all new hires on or after July 1, 2007 and all new hires on or after July 1, 2007 would become participants in the new DC plan. The calculations in this report are based on the final June 30, 2004 SBCERS actuarial valuation report.

June 30, 2004 actuarial valuation

The June 30, 2004 actuarial valuation resulted in a composite employer rate of 18.11%, consisting of a normal cost rate of 11.48% and a UAAL rate of 6.63%. The UAAL rate was based on a 15-year amortization of the \$199.6 million unfunded actuarial accrued liability as of that date. For simplicity purposes, we assume these same valuation results (normal cost and UAAL) exist at the time the proposed DC plan is implemented.

Implications of the DC Proposal on SBCERS Funding

Normal Cost

We do not foresee any immediate change to the 11.48% normal cost rate. Of course, the dollar contribution for normal cost will decrease over time once SBCERS is closed to new membership and new County employees enter the DC plan. The normal cost rate will change over time depending on turnover for the current members. If turnover is such that the average entry age increases, then the normal cost rate will likely increase gradually over time. Conversely, if the average entry age decreases, then the normal cost rate will likely decrease gradually over time.

UAAL Amortization

SBCERS currently uses a 15-year amortization period. At each valuation date, any new UAAL or surplus is amortized over a 15-year declining period. Closing SBCERS off to new members

will result in a gradual decrease in the average working lifetime of the current active members. In approximately 30 or so years, this average will wind its way down to zero, as the last current active member retires. If the DC plan is implemented and membership in SBCERS is cut off, we would be comfortable with the following amortization approach: Keep a 15-year methodology period in effect for 15 years, then reduce the period by one year every year out to 30 years after the DC plan is implemented.

Currently, the UAAL amortization is calculated assuming that covered payroll increases at the long-term inflation assumption of 4.50% per year and we assume a constant covered active membership. Once the DC plan is implemented, we can still incorporate a 4.50% payroll growth assumption, but we are required by GASB and actuarial standards to reflect the decline in the covered payroll base that will occur with the closing of SBCERS to new members. All else being equal, this alone will increase the up-front amortization rate and dollars, simply because the payroll in later years will not be as high as we had previously estimated and the shortfall must be made up in the earlier years.

Another alternative is to convert to a flat dollar UAAL payment over 15 years.

Defined Contribution Plan Features

Although not all the features of the proposed DC plan have been spelled out in the proposals, for purposes of this report we have assumed that Santa Barbara County would contribute 6.0% of pay (General members) and 9% of pay (Safety members) into the DC plan for all new members hired on or after the date the DC plan is implemented.

We assumed that total County payroll would increase with the current inflation assumption of 4.50% per year and that members that retire or terminate from SBCERS are replaced by new employees who enter the proposed DC plan. We also assumed that the starting pay for future employees under the DC plan will be 5% higher than would otherwise be the case. This adjustment is intended to account for the fact that future hires will require a higher starting salary to make up for the shortfall of DC benefits compared to DB benefits.

Long Range Costs

If SBCERS is closed to new membership, many factors that affect funding for SBCERS may change, but these factors are impossible to predict at this time. Examples of these unknowns are:

1. The DC plan proposals mention the ability of current SBCERS members to move their interest in SBCERS to the new DC plan. Exactly what amounts are to be transferred is not clearly spelled out in the proposals. For this reason, we have not incorporated any assumption for transfers in our projections.
2. The projections in this report are built on the presumption that all current actuarial assumptions are met indefinitely. Any actuarial gains or losses will result in savings or additional costs being different than our projections. Examples could include investment gains or losses or improvements in life expectancy.

3. Any future decision by the Board of Retirement to move to a more conservative investment mix (on account of the closing of SBCERS to new membership) will lead to loss of investment income and a corresponding increase in required contributions (refer to Scenarios 2, 3 and 4).

Scenarios

We have prepared projections of costs under four scenarios. Scenario 1 assumes that the Retirement Board maintains the current investment mix and the current investment return assumption of 8.16% is maintained indefinitely. Scenario 2 incorporates an assumption that the Retirement Board adopts a more conservative investment policy resulting in a decrease in the long-term investment return to 6%. The reduction to 6% is assumed to take place gradually over the 10-year period starting immediately after SBCERS is closed off to new membership. Scenario 3 is the same as Scenario 2 except the move to a 6% return takes place gradually over a 30-year period. Scenario 4 is the same as Scenario 2 except the move to 6% takes place over the 10-year period starting 10 years after the DC system is implemented.

Results

Scenario 1: The year-by-year projected costs for the SBCERS (as an open system with no changes) and the proposed SBCERS (closed to new membership)/DC system are shown in the attached table. Implementing the DC plan will actually cost the County more for the first four years. This is because the amortization of the UAAL has to be increased more than the savings that result from new employees being brought in under the less expensive DC plan. However, after the first few years, the County would actually realize a savings for the new DC plan.

Scenario 2: Same as Scenario 1 except it is assumed that the Retirement Board changes to a more conservative investment policy, resulting in a lowering of the actuarial assumption to 6% over a ten-year period starting immediately after SBCERS is closed to new membership. Investment returns are also assumed to be reduced to 6% over the same period and are assumed to remain at 6% indefinitely. The more conservative investment policy results in a significant loss of investment earnings, most of which must be made up for by increases in County contributions for normal cost and UAAL. Member contributions must also be increased to account for the lower actuarial assumption.

Scenario 3

This Scenario is the same as Scenario 2, but we assumed the investment return assumption would decrease from the current 8.16% to 6.0% gradually over the 30 years of the projection. The more conservative investment policy results in a significant loss of investment earnings, most of which must be made up for by increases in County contributions for normal cost and UAAL. Member contributions must also be increased to account for the lower actuarial assumption.

Mr. Oscar Peters

April 6, 2005

Page - 4 -

Scenario 4

This Scenario is the same as Scenario 2, but we assumed the investment return assumption would decrease from the current 8.16% to 6.0% gradually over years ten to twenty in the projection. This change in investment policy will result in a loss of investment return and a corresponding increase in County contributions and member contributions. The results are similar to Scenarios 2 and 3.

Conclusion

The closing of SBCERS will not necessarily result in the employer savings that are being discussed by the proponents of the proposed DC system. In fact, the long-term result will most likely be additional costs to the County under reasonable sets of assumptions.

Please let us know if you have any questions on our cost projections.

Sincerely,

Michael Moehle
Principal and Consulting Actuary

Eva Yum
Director and Consulting Actuary

Santa Barbara Employees Retirement System

SCENARIO 1: No Change in Investment Policy

Impact of Closing Off the Association to New Membership
Results are in Millions of Dollars

	Current System No Changes	Closed Defined Benefit System	New Defined Contribution System	Total DB/DC System	Savings/ (Additional Costs)	Cumulative Savings/ (Additional Costs)
Year	Annual Contributions	Annual Contributions	Annual Contributions	Annual Contributions	Annual Contributions	Annual Contributions
1	48.4	56.4	0.4	56.8	(8.4)	(8.4)
2	54.5	60.8	1.7	62.5	(8.0)	(16.4)
3	58.6	61.2	3.0	64.2	(5.6)	(22.0)
4	60.4	57.2	4.4	61.6	(1.2)	(23.2)
5	61.2	51.5	5.9	57.4	3.8	(19.4)
6	63.9	49.6	7.4	57.0	6.9	(12.5)
7	66.8	47.5	9.0	56.5	10.3	(2.2)
8	69.8	45.6	10.6	56.2	13.6	11.4
9	72.9	43.5	12.3	55.8	17.1	28.5
10	76.2	41.5	14.1	55.6	20.6	49.1
11	79.7	39.4	15.9	55.3	24.4	73.5
12	83.2	37.3	17.9	55.2	28.0	101.5
13	87.0	35.3	19.9	55.2	31.8	133.3
14	85.4	33.4	21.9	55.3	30.1	163.4
15	76.8	31.5	24.0	55.5	21.3	184.7
16	65.0	29.6	26.2	55.8	9.2	193.9
17	60.3	27.9	28.5	56.4	3.9	197.8
18	59.8	26.1	30.9	57.0	2.8	200.6
19	64.1	24.4	33.3	57.7	6.4	207.0
20	70.8	22.8	35.8	58.6	12.2	219.2
21	74.0	21.2	38.3	59.5	14.5	233.7
22	77.3	19.6	41.0	60.6	16.7	250.4
23	80.8	17.9	43.7	61.6	19.2	269.6
24	84.5	16.3	46.6	62.9	21.6	291.2
25	88.3	14.8	49.5	64.3	24.0	315.2
26	92.2	13.2	52.5	65.7	26.5	341.7
27	96.4	11.7	55.7	67.4	29.0	370.7
28	100.7	10.1	59.0	69.1	31.6	402.3
20	105.3	8.8	62.3	71.1	34.2	436.5
30	110.0	7.9	65.7	73.6	36.4	472.9

Santa Barbara Employees Retirement System

SCENARIO 2: Change in Investment Policy

Investment Return Assumption Lowered to 6% Over First 10 years

Impact of Closing Off the Association to New Membership
Results are in Millions of Dollars

Year	Current System No Changes Annual Contributions	Closed Defined Benefit System Annual Contributions	New Defined Contribution System Annual Contributions	Total DB/DC System Annual Contributions	Savings/ (Additional Costs) Annual Contributions	Cumulative Savings/ (Additional Costs) Annual Contributions
1	48.4	56.4	0.4	56.8	(8.4)	(8.4)
2	54.5	67.4	1.7	69.1	(14.6)	(23.0)
3	58.6	74.8	3.0	77.8	(19.2)	(42.2)
4	60.4	78.4	4.4	82.8	(22.4)	(64.6)
5	61.2	80.7	5.9	86.6	(25.4)	(90.0)
6	63.9	87.2	7.4	94.6	(30.7)	(120.7)
7	66.8	93.7	9.0	102.7	(35.9)	(156.6)
8	69.8	101.0	10.6	111.6	(41.8)	(198.4)
9	72.9	108.2	12.3	120.5	(47.6)	(246.0)
10	76.2	115.9	14.1	130.0	(53.8)	(299.8)
11	79.7	123.5	15.9	139.4	(59.7)	(359.5)
12	83.2	116.1	17.9	134.0	(50.8)	(410.3)
13	87.0	109.3	19.9	129.2	(42.2)	(452.5)
14	85.4	102.7	21.9	124.6	(39.2)	(491.7)
15	76.8	96.5	24.0	120.5	(43.7)	(535.4)
16	65.0	90.2	26.2	116.4	(51.4)	(586.8)
17	60.3	85.0	28.5	113.5	(53.2)	(640.0)
18	59.8	79.5	30.9	110.4	(50.6)	(690.6)
19	64.1	74.3	33.3	107.6	(43.5)	(734.1)
20	70.8	69.3	35.8	105.1	(34.3)	(768.4)
21	74.0	64.3	38.3	102.6	(28.6)	(797.0)
22	77.3	59.4	41.0	100.4	(23.1)	(820.1)
23	80.8	54.2	43.7	97.9	(17.1)	(837.2)
24	84.5	49.1	46.6	95.7	(11.2)	(848.4)
25	88.3	44.6	49.5	94.1	(5.8)	(854.2)
26	92.2	39.6	52.5	92.1	0.1	(854.1)
27	96.4	34.8	55.7	90.5	5.9	(848.2)
28	100.7	29.8	59.0	88.8	11.9	(836.3)
29	105.3	25.7	62.3	88.0	17.3	(819.0)
30	110.0	22.4	65.7	88.1	21.9	(797.1)

Santa Barbara Employees Retirement System

SCENARIO 3: Change in Investment Policy

Investment Return Assumption Lowered to 6% Over 30 years

Impact of Closing Off the Association to New Membership

Results are in Millions of Dollars

Year	Current System No Changes Annual Contributions	Closed Defined Benefit System Annual Contributions	New Defined Contribution System Annual Contributions	Total DB/DC System Annual Contributions	Savings/ (Additional Costs) Annual Contributions	Cumulative Savings/ (Additional Costs) Annual Contributions
1	48.4	56.4	0.4	56.8	(8.4)	(8.4)
2	54.5	60.8	1.7	62.5	(8.0)	(16.4)
3	58.6	61.2	3.0	64.2	(5.6)	(22.0)
4	60.4	64.6	4.4	69.0	(8.6)	(30.6)
5	61.2	58.6	5.9	64.5	(3.3)	(33.9)
6	63.9	56.4	7.4	63.8	0.1	(33.8)
7	66.8	63.0	9.0	72.0	(5.2)	(39.0)
8	69.8	60.4	10.6	71.0	(1.2)	(40.2)
9	72.9	57.5	12.3	69.8	3.1	(37.1)
10	76.2	65.4	14.1	79.5	(3.3)	(40.4)
11	79.7	61.9	15.9	77.8	1.9	(38.5)
12	83.2	58.5	17.9	76.4	6.8	(31.7)
13	87.0	67.3	19.9	87.2	(0.2)	(31.9)
14	85.4	63.4	21.9	85.3	0.1	(31.8)
15	76.8	59.7	24.0	83.7	(6.9)	(38.7)
16	65.0	69.5	26.2	95.7	(30.7)	(69.4)
17	60.3	65.5	28.5	94.0	(33.7)	(103.1)
18	59.8	61.3	30.9	92.2	(32.4)	(135.5)
19	64.1	72.9	33.3	106.2	(42.1)	(177.6)
20	70.8	68.1	35.8	103.9	(33.1)	(210.7)
21	74.0	63.2	38.3	101.5	(27.5)	(238.2)
22	77.3	76.9	41.0	117.9	(40.6)	(278.8)
23	80.8	70.3	43.7	114.0	(33.2)	(312.0)
24	84.5	63.7	46.6	110.3	(25.8)	(337.8)
25	88.3	81.0	49.5	130.5	(42.2)	(380.0)
26	92.2	72.2	52.5	124.7	(32.5)	(412.5)
27	96.4	63.4	55.7	119.1	(22.7)	(435.2)
28	100.7	88.7	59.0	147.7	(47.0)	(482.2)
29	105.3	76.7	62.3	139.0	(33.7)	(515.9)
30	110.0	66.9	65.7	132.6	(22.6)	(538.5)

Santa Barbara Employees Retirement System

SCENARIO 4: Change in Investment Policy

Investment Return Assumption Lowered to 6% Over Years 10 to 20

Impact of Closing Off the Association to New Membership
Results are in Millions of Dollars

Year	Current System No Changes Annual Contributions	Closed Defined Benefit System Annual Contributions	New Defined Contribution System Annual Contributions	Total DB/DC System Annual Contributions	Savings/ (Additional Costs) Annual Contributions	Cumulative Savings/ (Additional Costs) Annual Contributions
1	48.4	56.4	0.4	56.8	(8.4)	(8.4)
2	54.5	60.8	1.7	62.5	(8.0)	(16.4)
3	58.6	61.2	3.0	64.2	(5.6)	(22.0)
4	60.4	57.2	4.4	61.6	(1.2)	(23.2)
5	61.2	51.5	5.9	57.4	3.8	(19.4)
6	63.9	49.6	7.4	57.0	6.9	(12.5)
7	66.8	47.5	9.0	56.5	10.3	(2.2)
8	69.8	45.6	10.6	56.2	13.6	11.4
9	72.9	43.5	12.3	55.8	17.1	28.5
10	76.2	41.5	14.1	55.6	20.6	49.1
11	79.7	49.6	15.9	65.5	14.2	63.3
12	83.2	57.8	17.9	75.7	7.5	70.8
13	87.0	66.2	19.9	86.1	0.9	71.7
14	85.4	74.7	21.9	96.6	(11.2)	60.5
15	76.8	83.4	24.0	107.4	(30.6)	29.9
16	65.0	91.9	26.2	118.1	(53.1)	(23.2)
17	60.3	101.4	28.5	129.9	(69.6)	(92.8)
18	59.8	110.8	30.9	141.7	(81.9)	(174.7)
19	64.1	120.7	33.3	154.0	(89.9)	(264.6)
20	70.8	131.0	35.8	166.8	(96.0)	(360.6)
21	74.0	121.6	38.3	159.9	(85.9)	(446.5)
22	77.3	112.4	41.0	153.4	(76.1)	(522.6)
23	80.8	102.8	43.7	146.5	(65.7)	(588.3)
24	84.5	93.0	46.6	139.6	(55.1)	(643.4)
25	88.3	84.7	49.5	134.2	(45.9)	(689.3)
26	92.2	75.4	52.5	127.9	(35.7)	(725.0)
27	96.4	66.2	55.7	121.9	(25.5)	(750.5)
28	100.7	56.9	59.0	115.9	(15.2)	(765.7)
20	105.3	49.1	62.3	111.4	(6.1)	(771.8)
30	110.0	42.8	65.7	108.5	1.5	(770.3)