COUNTY OF SAN MATEO
Inter-Departmental Correspondence
County Manager

Date: June 25, 2013
Board Meeting Date: July 9, 2013
Special Notice / Hearing: None
Vote Required: Majority

To: Honorable Board of Supervisors

From: John L. Maltbie, County Manager

Subject: 2012-13 Grand Jury Response- SamCERA's Unfunded Liability: the Elephant in the Room

RECOMMENDATION:
Approve the Board of Supervisor's response to the 2012-13 Grand Jury report titled: SamCERA's Unfunded Liability: The Elephant in the Room.

BACKGROUND:
On April 15, 2013, the Grand Jury filed a report titled: SamCERA's Unfunded Liability: The Elephant in the Room. The Board of Supervisors is required to submit comments on the findings and recommendations pertaining to the matters under control of the County of San Mateo within ninety days. The County's response to the report is due to Hon. Richard C. Livermore no later than July 15, 2013.

Acceptance of this report contributes to the Shared Vision 2025 outcome of a Collaborative Community by ensuring that all Grand Jury findings and recommendations are thoroughly reviewed by the appropriate County departments and that, when appropriate, process improvements are made to improve the quality and efficiency of services provided to the public and other agencies.

DISCUSSION:
Findings:

F1. Board of Supervisors has failed adequately to address SamCERA's unfunded liability because it has not (i) properly monitored the performance of SamCERA's investment portfolio, (ii) made contributions sufficient to cause SamCERA's funding to be sound or (iii) taken steps to reduce the County's retirement costs significantly.

The County Board of Supervisors Response to F1: Disagree.

(i) The County has closely monitored the performance of SamCERA's investment portfolio. For the last two fiscal years, the County has exceeded funding requirements and met or exceeded its actuarial and legal commitments to the retirement plan.

(ii) The County has approved holding the average contribution rate at a level higher than called for by the actuarial process. The County contributed an additional $11.5 million in FY 2011-12, and is contributing a projected additional $12.7 million in FY 2012-13. The result of these actions is that the unfunded liability is being paid down at a faster rate than anticipated.

(iii) In order to reduce the County's retirement costs, the County adopted lower benefit formulas for new employees, made the statewide PEPRA retirement plan effective for new SamCERA members, and eliminated approximately 500 positions over the last five years.

F2. SamCERA's Board of retirement has not adequately addressed SamCERA's unfunded liability in that it has adopted an assumed rate of return that does not sufficiently recognize the guaranteed status of its participants' benefits.

The County Board of Supervisors Response to F2: Disagree.

The County approved one of the lowest assumed earning rates of all California plans for the SamCERA plan. The County will recognize the "guaranteed status" of SamCERA benefits in the Comprehensive Annual Financial Report (CAFR). GASB has emphasized that its new statements should not affect pension funding decisions and that such decisions should continue to be determined by the plans and their actuaries.

F3. SamCERA's unfunded liability is materially greater than $962,282,000 as reported in the SamCERA CAFR for FY2012, and is probably closer to $2 billion.

The County Board of Supervisors Response to F3: Disagree.

The current standards set by GASB and the Actuarial Standards Board prevents SamCERA from using the approach on which the Grand Jury bases its finding.

F4. SamCERA's assumed rate of return of 7.5% is unrealistic given the actual rate of return of SamCERA's investments over the past 10 years (5.54%) and the discount rate (4%) used by the 100 largest public companies in calculating their unfunded liabilities.

The County Board of Supervisors response to F4: Disagree.

As of March 31, 2013, the fund had earned a net preliminary return of 7.6% over the prior ten years. These are the most current figures available and exceed the current assumed earning rate of 7.5%. The discount rates for corporate pension plan liabilities are calculated under a separate set of federal laws and accounting rules.

F5. SamCERA's investment performance over the past 10-year period has been poor.

The County Board of Supervisors response to F5: Disagree.

As of March 31, 2013, the fund had earned a net preliminary return of 7.6% over the prior ten years, which is higher than the assumed earnings rate of 7.5%. Considering the widespread losses suffered by other investment funds in the wake of the financial crisis and economic recession, SamCERA's investment performance is commendable.

F6. SamCERA's Board of Retirement can create liabilities that are required by law to be paid by the Board of Supervisors.

The County Board of Supervisors response to F6: Disagree.

Pension liabilities are created by employees earning pension benefits in accordance with the Government Code based on plans approved by the Board of Supervisors and/or mandated by state law. These costs are paid for by employee contributions, employer contributions, and investment earnings.

F7. County taxpayers, not SamCERA's beneficiaries, bear the economic burden of SamCERA's investment performance because reduced County services, tax increases, or both, are required to pay SamCERA's unfunded liability.

The County Board of Supervisors response to F7: Partially Disagree.

In addition to tax revenues, retirement costs are paid for by member contributions and investment earnings.

F8. There is no assurance that SamCERA's change in investment strategy to include a significant allocation to alternative investments will produce better returns than the previous strategy or reduce the risk of its portfolio.

The County Board of Supervisors response to F8: Agree.

There is no assurance regarding any investment strategy that involves investment risk.

F9. The Board of Supervisors has not committed to using any portion of Measure A sales tax revenues to increase contributions to SamCERA to pay down SamCERA's unfunded liability.

The County Board of Supervisors response to F9: Agree.

At the time of this report, the Board of Supervisors has not committed to using any portion of Measure A sales tax revenues to increase contributions to SamCERA to pay down the unfunded liability. However, on August 6, 2013, the Board of Supervisors will hear a presentation on the impacts of using one-time funding sources such as Educational Revenue Augmentation Fund (ERAF) Reserves to make lump sum payments towards the unfunded pension liability.

F10. The effects of the 2011 Changes and the adoption of PEPRA, both intended to reduce retirement costs, are minimal, apply principally to new hires, and will not yield significant savings when compared to the size of SamCERA's unfunded liability.

The County Board of Supervisors response to F10: Disagree.

The reduction in retirement costs due to PEPRA and the 2011 changes will begin at a lower level and increase every year as the percentage of employees with these lower benefit plans increases.

F11. The longer the Board of Supervisors delays in eliminating SamCERA's unfunded liability, the greater the cost will be to do so, and the more the burden of doing so will fall on the next generation.

The County Board of Supervisors response to F11: Disagree.

The Board of Supervisors has made timely and appropriate payments to the retirement system as recommended by the independent actuary and it has taken steps to reduce costs. No other California plan has a shorter fixed amortization period than SamCERA's 15-year amortization period for its unfunded liability.

F12. The financial reporting in the SamCERA PAFR can be improved.

The County Board of Supervisors response to F12: Agree.

Recommendations:

The Grand Jury recommends that the County's Board of Supervisors do the following:

R6. Implement GASB Statement 68 for FY 2014.

The County Board of Supervisors response to R6: The recommendation will be implemented for FY 2015.

According to the County's Comprehensive Annual Financial Report for fiscal year ending FY 2012 (page iv): "The Governmental Accounting Standards Board (GASB) has released new pronouncements (GASB Statements 67 and 68) to bring public pension accounting more in line with the private sector rules. GASB Statement 67 will be implemented by SamCERA for the fiscal year ending June 30, 2014, and GASB

Statement 68 will be implemented for the County for the fiscal year ending June 30, 2015 (SamCERA must implement GASB Statement 67 one year before the County implements GASB Statement 68)."

R7. Appoint to the Board of Retirement only individuals who possess substantial experience managing or overseeing investment portfolios, either by professional training, or by business or personal experience.

The County Board of Supervisors response to R7: The recommendation has already been implemented.

County Employees Retirement Law of 1937, California Codes Government Code Section 31520 states that, "members shall be qualified electors of the county who are not connected with county government in any capacity, except one may be a supervisor and one may be a retired member, and shall be chosen by the board of supervisors."

The law does not require any additional qualifications or experience for Board members appointed by the Board of Supervisors. However, the Board of Supervisors have taken it upon themselves to appoint members to the Board of Retirement who have substantial experience analyzing financial statements, managing investment portfolios, and overseeing retirement funds. Currently, all members appointed by the Board possess related experience.

R8. Formally review in open session on a quarterly basis the investment performance of SamCERA.

The County Board of Supervisors response to R8: The recommendation will not be implemented.

The Board of Retirement meets on a monthly basis to conduct normal business, which usually includes an investment performance review. It is unreasonable for the Board of Supervisors to meet on a quarterly basis to do the same. David Bailey, the Chief Executive Officer of SamCERA is available to attend Board of Supervisors meetings and answer questions from Board members upon request. In addition, The Board of Retirement meeting agendas and minutes are posted regularly to SamCERA's website, along with other relevant materials such as Quarterly Investment Performance Reports.

R9. Give higher priority to funding SamCERA's unfunded liability, an obligation that already exists, than to other new or expanded programs it may contemplate.

The County Board of Supervisors response to R9: The recommendation will not be implemented.

The Board of Supervisors is committed to eliminating the County's structural deficit. This commitment limits other new or expanded programs from being added without a specific funding source or a sustainable funding plan. In addition, the Board of Supervisors cannot adopt a policy that could potentially limit the provision of essential services to the County's most needy residents.

R10. Adopt the goal that SamCERA's funded ratio should be 100% and that its minimum funded ratio is 90%.

The County Board of Supervisors response to R10: The recommendation will not be implemented.

According to the County's Comprehensive Annual Financial Report for fiscal year ending FY 2012 (page iii): "The County's funded ratio of 73.3% is higher than the average funded ratio, 70.6%. The County's funded ratio is significantly better than the State's ratio of 59.4%." In addition, SamCERA's retirement plan is amortized over a 15-year period (the shortest of all California plans); the assumed earnings rate of 7.5% is one of the lowest in the State; and the County has not issued Pension Obligation Bonds.

R11. At a minimum, set the County's annual contribution to SamCERA attributable solely to the unfunded liability to the amount necessary to achieve a funded ratio of at least 90% on or before June 30, 2023.

The County Board of Supervisors response to R11: The recommendation has already been implemented.

Based on the current structure and the most recent actuarial projections, the County will achieve a 89% funded ratio by 2020, assuming SamCERA achieves the assumed earnings rate.

R12. Once the minimum funded ratio of 90% is achieved, at a minimum each year thereafter, set the County's annual contribution attributable solely to the unfunded liability to the amount necessary to maintain a funded ratio of at least 90%.

The County Board of Supervisors response to R12: The recommendation will not be implemented.

Fluctuations in the County's unfunded liability are dependent on investment returns. The County's approach is to smooth the investment gains and losses from year to year to ensure that the General Fund budget can be managed effectively and essential services can be provided to the public in a consistent manner.

R13. If they withstand judicial challenge, take all steps necessary to implement pension changes similar to those passed by San Jose's voters.

The County Board of Supervisors response to R13: The recommendation will not be implemented.

In order to reduce the County's retirement costs, the County adopted lower benefit formulas for new employees, made the statewide PEPRA retirement plan effective for new SamCERA members, and eliminated approximately 500 positions over the last five years.

The Grand Jury recommends that SamCERA's Board of Retirement and the County's Board of Supervisors do the following:

R14. Acknowledge that the reported unfunded liability of $962,282,000 is materially understated if either a risk free rate of return or SamCERA's actual rate of return over the past 10 years is used in its calculation.

The County Board of Supervisors response to R14: The recommendation will not be implemented.

The recommendation is not in accordance with the standards set by GASB and the Actuarial Standards Board.

R15. Annually compare SamCERA's unfunded liability calculated in accordance with GASB Statement 68 with its unfunded liability calculated utilizing a risk free rate of return and SamCERA's actual rate of return over the past 10 years.

The County Board of Supervisors response to R15: The recommendation will not be implemented.

It is not realistic or valuable to calculate SamCERA's unfunded liability using a "risk-free" rate of return. As stated previously, GASB has emphasized that its new statements should not affect pension funding decisions.

FISCAL IMPACT:
There is no Net County Cost associated with approving this report.