SAMCERA'S UNFUNDED LIABILITY:
THE ELEPHANT IN THE ROOM[1]

SUMMARY

SamCERA is San Mateo County's retirement plan. As a result of the recent financial crisis, compounded by SamCERA's lackluster investment performance, SamCERA's retirement fund has gone from being essentially 100% funded in fiscal year (FY) 2001 to having an acknowledged funding shortfall, called an "unfunded liability," of about $1 billion in fiscal FY2012. SamCERA's acknowledged unfunded liability equates to $1,500 for every man, woman, and child in San Mateo County. Moreover, based upon current economic conditions and SamCERA's actual investment performance, as opposed to its investment assumptions, the unfunded liability is closer to $2 billion. The County's taxpayers, not SamCERA's beneficiaries, bear the burden of this funding shortfall through reduced County services, higher taxes, or both.

For FY2013, as a partial payment on SamCERA's acknowledged unfunded liability, the County has budgeted a contribution to SamCERA of about $92.5 million. This is more than the County has budgeted for FY2013 for each of the Sheriff's Office, capital projects, road construction and operations, the County library system, or parks.

Each year, SamCERA sets the rate of return it anticipates earning on its investments, currently 7.5% annually. On average, SamCERA has not met its anticipated rate of return over the past one, five, or ten-year periods. SamCERA's investment performance ranking among its peers for each of those periods has been in the bottom 20%. SamCERA's investment returns would have been better had it simply invested in a passively managed balanced index fund. In short, SamCERA's investment performance has been poor.

How are SamCERA and the County addressing the unfunded liability problem?

For its part, SamCERA in 2010 changed its asset allocation policy to require that 20% of its portfolio be in alternative investments such as private equity, risk parity, commodities, and hedge funds. This change is too recent to ascertain its effect. For several years, however, the California Public Employees Retirement System (CalPERS) has used a similar investment strategy with results even worse than those of SamCERA under its "old" investment policy.

SamCERA also amortizes (pays down) its unfunded liability over a shorter period than the law allows. Similar to a home mortgage, the shorter the amortization period, the lower the ultimate cost. The Grand Jury notes that separate from the cost savings, a shorter amortization period places more of the financial burden on the generation on whose watch the unfunded liability occurred, thereby lessening the financial burden on future generations.

For its part, the County has over the past four years or so reduced the number of County employees and, for the most part, frozen pay and restricted hiring. The Board of Supervisors also

[1] [A]n English metaphorical idiom for an obvious truth that is either being ignored or going unaddressed. The idiomatic expression also applies to an obvious problem or risk no one wants to discuss. Wikipedia, http://en.wikipedia.org/wiki/Elephant_in_the_room (March 28, 2013).

states that it has "already gone a long way in reducing retirement costs" by, among other things, reducing benefit formulas for new hires and establishing a higher age for the receipt of maximum pension benefits. The Grand Jury finds that the pay freeze, restricted hiring, and pension changes made by the County will not have a material effect on SamCERA's retirement costs or SamCERA's unfunded liability.

In 2012, the Board of Supervisors proposed and the voters approved Measure A, a 10-year increase in the sales tax within the County. The County Controller and County Manager have pointed out that some of the estimated $60 million annual increase in County revenues resulting from the passage of Measure A could be used to pay down SamCERA's unfunded liability. As of the date of this report, the Board of Supervisors has not committed to use Measure A funds to reduce SamCERA's unfunded liability.

Voters in the cities of San Jose and San Diego recently approved pension reform measures that, in part, affect current employees on a going forward basis and reduce those cities' pension obligations. The Board of Supervisors has not proposed any similar measure.

During its investigation, the Grand Jury examined several financial reports. One of them was the SamCERA Popular Annual Financial Report (SamCERA PAFR), a user-friendlier summary of the SamCERA Comprehensive Annual Financial Report. The Grand Jury noted that the SamCERA PAFR does not contain certain information that the public would find useful. For example, the SamCERA PAFR does not reveal that SamCERA's unfunded liability is about $1 billion or that its investments lost over $11 million in FY2012 after paying investment expenses.

Instead of meaningfully addressing SamCERA's unfunded liability problem, the Board of Supervisors has adopted a strategy best described as "hope:"

- Hope that it will not be required to increase its contribution to amortize SamCERA's unfunded liability

- Hope that SamCERA can achieve its assumed rate of return of 7.5% even though it has, on average, failed to achieve this rate of return over the past one, five, and ten years

- Hope that regulatory and bond rating agencies do not require the reporting of a larger unfunded liability

- Hope that recent pension changes will significantly reduce SamCERA's unfunded liability

- Hope that it will not be required to make changes to worker pay and pension benefits that will be unpopular with its employees

The Grand Jury recommends to SamCERA's Board of Retirement that it be more realistic in setting its assumed rate of return; improve the reporting of its financial results; and employ only money managers for the alternative investment portion of SamCERA's investment portfolio who rank in the top 10% of their peers.

The Grand Jury recommends to the County's Board of Supervisors that it implement GASB Statement 68 for FY2014; assure the financial qualifications of its appointees to the Board of Retirement; and formally review SamCERA's financial performance on a regular basis. The Grand Jury further recommends that the Board of Supervisors give priority to the funding of SamCERA's unfunded liability over other new or expanded programs; adopt a minimum funded ratio for SamCERA; and implement meaningful pension reform.

The Grand Jury recommends to SamCERA's Board of Retirement and the County's Board of Supervisors that they acknowledge that SamCERA's reported unfunded liability is materially understated.

ACRONYMS/GLOSSARY

Actuary – A business professional who deals with the financial impact of risk and uncertainty. Actuaries provide expert assessments of financial security systems, with a focus on their complexity, their mathematics, and their mechanisms.[2]

Adopted Budget – County of San Mateo's Adopted Budget for FY2013.

Board of Retirement – The governing board of SamCERA. The Board of Retirement is comprised of the San Mateo County Treasurer, four members elected by current and retired employees, and four members appointed by the San Mateo County Board of Supervisors.

Board of Supervisors – San Mateo County Board of Supervisors.

Controller – San Mateo County Controller.

County – San Mateo County, California, or the government of San Mateo County, California, as the context requires.

County Budget – County of San Mateo, California Adopted Budget for FY2012-2013.

County CAFR – County of San Mateo, California, *Comprehensive Annual Financial Report Fiscal Year Ended June 30, 2012*.

County PAFR – County of San Mateo, California, *Financial Highlights Fiscal Year Ended June 30, 2012*, also known as the *County Popular Annual Financial Report*.

County Responses – Written responses by the County administration to written questions posed by the Grand Jury during its investigation.

Funded ratio – A measurement of SamCERA's funding adequacy. Basically, this ratio is calculated by dividing the value of SamCERA's investment assets by SamCERA's liability to its plan participants, all as determined by SamCERA's actuary. The higher the ratio, the better position SamCERA is in to meet its liabilities.

[2] Wikipedia, http://en.wikipedia.org/wiki/Actuary.

Fiscal Year or FY – The period July 1 through June 30. For simplicity, a fiscal year will be referred to by the year in which it ends, e.g. FY2011-2012 is FY2012.

GASB – Governmental Accounting Standards Board, the independent organization that establishes and improves standards of accounting and financial reporting for U.S. state and local governments.[3]

Grand Jury – The 2012-2013 San Mateo County Civil Grand Jury.

Measure A – The one-half cent increase in the sales tax in San Mateo County for 10 years, approved by the voters on November 6, 2012, estimated to generate an additional $60 million in revenue annually.

Milliman Report – Milliman, Inc., *San Mateo County Employees' Retirement Association Actuarial Valuation* (June 30, 2012).

Moody's – Moody's Investors Service, a leading provider of credit ratings and research, covering debt instruments and securities.[4]

Rate of return - The gain or loss on an investment portfolio over a specified period, expressed as a percentage increase or decrease over the initial investment cost. An assumed rate of return is the rate expected to be earned on an investment portfolio. An actual rate of return is the rate actually earned on an investment portfolio.

SamCERA - The San Mateo County Employees Retirement Association, the County's retirement system, established in 1944. SamCERA is a cost-sharing multiple-employer defined benefit pension plan for substantially all permanent County employees, the San Mateo County Mosquito and Vector Control District, and the Superior Courts of San Mateo County. SamCERA is an independent legal entity separate from the County.

SamCERA CAFR – *SamCERA Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2012*.
SamCERA PAFR – *SamCERA Summary Annual Financial Report for the Fiscal Year Ended June 30, 2012*, also known as the *SamCERA Popular Annual Financial Report*.

SamCERA Responses – Written responses by SamCERA to written questions posed by the Grand Jury during its investigation.

Unfunded liability – An amount determined by SamCERA's independent actuary that expresses the excess of SamCERA's accrued liabilities (principally to plan beneficiaries) over the value of SamCERA's investment assets.[5]

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[3] GASB, *Facts about GASB*, 2012-2014.
[4] Moody's Corporation, http://www.moodys.com/Pages/atc.aspx (January 18, 2013.)
[5] The technical term for the unfunded liability is the Unfunded Accrued Actuarial Liability or UAAL.

BACKGROUND

Over the course of many years, the Board of Supervisors has granted generous benefits to County employees. For example, the Board approved retroactive pension increases for active employees in 2003 and again in 2005 for which no funds were set aside. Pension costs also rise as salaries increase and beneficiaries live longer. The County now pays $0.61 for fringe benefits, including retirement, in addition to every dollar of salary for County workers. This amount is slated to increase to $0.68 per dollar of salary over the next nine years.[6]

The effect of this generosity is now being felt. SamCERA's payments to its beneficiaries have increased 34% from FY2008 ($104.0 million) through FY2012 ($139.2 million).[7] While the median annual pension benefit is $23,981, the average benefit is $33,876. Twenty-four County retirees receive annual pensions of $150,000 - $199,000, and five receive annual pensions of more than $200,000.[8]

Retirement benefits, which are guaranteed by law, are funded by County and employee contributions to SamCERA, which invests these contributions in assets such as equities, fixed income, real estate, and the like. For the most part, the returns on these assets are not guaranteed. If these assets do not earn enough to assure payment of SamCERA's guaranteed benefits, an "unfunded liability" is created. This has happened to SamCERA.

The 2011-2012 San Mateo County Civil Grand Jury report entitled "Controlling the County's Escalating Retirement Costs" included a section that addressed, in part, SamCERA's unfunded liability and the rate of return it assumes it can earn. The report can be accessed at http://www.sanmateocourt.org/court_divisions/grand_jury/, and then by selecting "2011-2012" under "FINAL REPORTS."

Because of the dramatic impact SamCERA's unfunded liability and rate of return can have upon the County's financial well-being, the Grand Jury decided that further examination of these and related subjects was warranted.

METHODOLOGY

Documents and Reference Sources

- County CAFR
- County PAFR
- County Responses

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[6] 2011-2012 San Mateo County Civil Grand Jury, *Controlling the County's Escalating Retirement Costs*, pp. 5-6.

[7] SamCERA CAFRs for 2012 and 2009. Per the SamCERA CAFR for 2012, p. 30, the growth in benefit payments was due to the net increase in the number of retirees and beneficiaries and the increase in the average retirement allowance of additions to the retirement payroll.

[8] SamCERA Responses. In addition to their pensions, all SamCERA beneficiaries other than public safety members also receive Social Security

- Governmental Accounting Standards Board Statements 67 and 68
- Internet – various sources
- Milliman Report
- SamCERA CAFR
- SamCERA PAFR
- SamCERA Responses
- Various reports and articles

Interviews

The Grand Jury conducted interviews with appropriate County and SamCERA officials.

Written Questions

The Grand Jury posed written questions to County and SamCERA officials, both in letter and email formats.

DISCUSSION

Introduction

Pension discussions bore most people. Nevertheless, the ballooning of SamCERA's unfunded liability and poor performance of SamCERA's investments over the past 10 years are ample reasons to capture and hold the interest of County residents, their elected representatives, and those responsible for SamCERA's investment policies.

This report will examine the growth of SamCERA's unfunded liability, the historic rate of return on its investments, its decision to commit 20% of its portfolio to "alternative investments," its financial reporting, the County's review of SamCERA's performance, and approaches that have been and can be taken by the County and SamCERA to address the unfunded liability problem. This report will also set forth the Grand Jury's findings and recommendations for future action.

A Note about Rates

This report uses the term "rates" in several contexts. For example, there are assumed and actual rates of return, bond rates, and discount rates. The reader is cautioned to note carefully what particular rate is being used and why.

SamCERA's Acknowledged Unfunded Liability - $1 Billion[9]

SamCERA acknowledges an unfunded liability as of June 30, 2012, of $1.08 billion based on the market value of its investments.[10] Because of an accounting technique known as "smoothing" that spreads gains and losses over five-year periods, the unfunded liability reported in the SamCERA CAFR is $962,282,000. SamCERA adopted this smoothing technique effective with the June 30, 1995, valuation.[11] Smoothing is commonly used by public pension funds. This report will use the rounded figure of $1 billion in discussing SamCERA's acknowledged unfunded liability except when the more exact figure of $962,282,000 is used in making calculations.

It is difficult to grasp how much $1 billion is. To put this sum into perspective, consider the following:

- It would take 10 workers each earning $1 million a year an entire century to earn $1 billion
- $1 billion could buy 1,432 homes in the County[12]
- If $1 billion were divided equally among every household in the County, each would receive $3,878[13]

A billion dollars is a lot of money.

Pension payments to SamCERA by the County consist of two parts: the "normal cost" (the estimated amount necessary to fund benefits earned in the current year) and the cost to amortize the unfunded liability over multiple 15-year periods.[14] For example, for FY2012, the County contributed $47,001,291 as the "normal cost" and $103,948,470 as the amortization payment toward the unfunded liability, for a total payment of $150,949,761.[15] This total payment was 9% of the County's FY2012 annual budget. Table 1 shows the County's contributions to SamCERA for the past five years that are attributable solely to amortizing the acknowledged unfunded liability.

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[9] This report addresses only SamCERA's unfunded liability. It does not address the County's unfunded liability for other postemployment benefits (OPEB) that totaled $100 million as of June 30, 2012. In 2012, the County paid $19.45 million toward its OPEB obligations. County CAFR, pp. 64-67.

[10] SamCERA Responses.

[11] SamCERA CAFR, p. 95.

[12] Zillow, *San Mateo Home Prices and Home Valu*es, http:// http://www.zillow.com/local-info/CA-San-Mateo-home-value/r_13699/ - midpoint home valuation of $698,200.

[13] Bay Area Census, http://www.bayareacensus.ca.gov/counties/SanMateoCounty.htm -2010 Census number of County households = 257,837.

[14] For a detailed description of the amortization policy, see the County CAFR, p. 63, and the SamCERA CAFR, pp. 41, 89.

[15] SamCERA CAFR, p. 61; SamCERA Responses.

Table 1[16]

County Contributions Toward SamCERA's Unfunded Liability

Fiscal Year Ending June 30	$ Amount Of County Contribution Attributable Solely To Unfunded Liability
2008	$50,121,685
2009	$52,675,937
2010	$53,693,351
2011	$105,602,644
2012[17]	$103,948,470

The County's budgeted unfunded liability contribution for FY2013 is about $92.5 million.[18] This means that although SamCERA's acknowledged unfunded liability increased by over $120 million from FY2011 to FY2012, and the County's budget increased by almost $115 million from FY2012 to FY2013, the County will contribute about $11.5 million less toward SamCERA's unfunded liability this budget year.[19] Thus, the County reduced its unfunded liability contribution when it should have increased it.

To put into perspective the unfunded liability contribution of $92.5 million by the County for FY2013, below are some other budgeted County expenses for that year:

- Sheriff's Office - $89.7 million[20]
- Capital Projects - $83 million
- Road Construction and Operations - $56.6 million
- County Library - $31.7 million
- Parks - $ 8.6 million

SamCERA's acknowledged, actuarially determined unfunded liability on a smoothed basis has increased by 64%, from FY2008 ($587,285,000) to FY2012 ($962,282,000).[21] As stated in the

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[16] Content sourced from SamCERA Responses.
[17] Per the SamCERA Responses, the calculated amount was $91,899,160, but the County increased the payment to the amount shown.
[18] County Responses; SamCERA Responses.
[19] SamCERA CAFR; County Budget; County Responses.
[20] County Responses. This represents the "net county cost" for the Sheriff's Department after reimbursement from other governmental agencies that the Department provides with police services such as the Town of Woodside, Millbrae, BART, and Caltrain.
[21] SamCERA CAFR, p. 100.

Report of the State Budget Crisis Taskforce, California Report (California Report), "Actuarial methods generally underestimate true liabilities substantially." The most common reason an understatement occurs is that a plan uses an unrealistically high rate of return. As seen below, SamCERA's assumed rate of return has been consistently overstated.

One way to understand the gravity of the unfunded liability problem is to view the unfunded liability as a very large bond debt. The County annually establishes a debt service limit that is applicable to County debt that has not been approved by the voters.[22] The debt service limit for FY2013 is $72 million of which $29 million has been used.[23]

County voters do not approve the creation of SamCERA's unfunded liability. Even so, the County Employees Retirement Law of 1937 obligates the Board of Supervisors to pay SamCERA's unfunded liability just as it is obligated to service its debt.[24] If, SamCERA's acknowledged unfunded liability were viewed as non-voter approved County debt and the annual amortization payments as debt service, then the debt service for the County for FY2013 would be 85% over the legal limit.[25]

Does SamCERA have sufficient assets to meet its obligations to its plan participants? The "funded ratio" is one means to answer this question. As stated in the SamCERA CAFR, "The greater a system's funded ratio, the better position it will be in to meet all of its future liabilities."[26]

Based upon current methodology, SamCERA's funded ratio reached almost 100% in FY2001.[27] Since then, the funded ratio, based upon the acknowledged unfunded liability, has fallen to 72% as seen in Table 2 below:

Table 2[28]

SamCERA's Acknowledged Funded Ratio

Valuation Date As Of 6/30	Funded Ratio
2001	98.6%
2002	85.3%
2003	76.0%
2004	75.6%
2005	74.2%

22 County CAFR, p. vii.
23 Adopted Budget, p. 6-36.
24 County Employees Retirement Law of 1937, Sections 31453 and 31454.
25 The 2013 debt service limit is $72,032,373, of which $29,139,115 has been "used." Adding the County's 2013 unfunded liability payment of $103,948,470 would result in a total "debt service" of $133,087,585, which is 185% of the debt service limit.
26 SamCERA CAFR, p. 62.
27 Milliman Report, p. 6; SamCERA's Investment Policy (as revised January 2102), p. 3.
28 SamCERA CAFR, p. 61; SamCERA CAFR for FY2004-2005.

Valuation Date As Of 6/30	Funded Ratio
2006	75.4%
2007	77.4%
2008	79.1%
2009	63.9%
2010	70.3%
2011	74.1%
2012	72.0%

SamCERA's funded ratio slips to 68.6% if the market, rather than smoothed, value of its investments is used in the calculation.[29] Curiously, one of SamCERA's current online Investment Objectives is to "Provide for the full funding of the Pension Benefit Obligation by the year 2012."[30]

SamCERA's More Likely Unfunded Liability - $2 Billion

During the course of its investigation, the Grand Jury reviewed credible evidence that SamCERA's unfunded liability is likely closer to $2 billion than the $1 billion acknowledged by SamCERA.

If $1 billion is a lot of money, then $2 billion is *really* a lot of money.

The County and SamCERA follow the accounting principles and reporting guidelines set forth by the Governmental Accounting Standards Board (GASB).[31] In June 2012, GASB issued two new statements relating to the accounting and financial reporting of pensions by state and local governments and pension plans. (Appendix A). Statement 67, effective for FY2014, applies to SamCERA. Statement 68, effective for FY2015, applies to the County. (GASB encourages earlier implementation of these statements.) Under these statements, SamCERA's unfunded liability will be measured at market value, not on a "smoothed" value as is current practice.[32] SamCERA's acknowledged unfunded liability at market value is $1.08 billion.

SamCERA currently calculates its unfunded liability using its assumed rate of return of 7.5%.[33] Under GASB Statement 68, the County may continue using its assumed rate of return but only as to "available pension plan assets that are expected to be invested using a strategy to achieve that return." Thereafter, SamCERA will be required to use a different rate in calculating the unfunded liability. Specifically, the County will be required to use a "tax-exempt, high-quality (an average

[29] Milliman Report, p. 11.

[30] http://samcera.org/investments.html (February 6, 2013).

[31] County CAFR, pp. 35, 62.

[32] Governmental Accounting Standards Board, *New GASB Pension Statements to Bring about Major Improvements in Financial Reporting*, June 2012.

[33] SamCERA Responses.

rating of AA/Aa or higher, including equivalent ratings) 20-year general bond index rate."[34] The 20-Bond Index is one such index.[35] Its yield as of January 10, 2013, was 3.6%.[36] If SamCERA is required to use this lower rate of return, then SamCERA's projected earnings will be less, thereby causing its unfunded liability to increase. This lower rate, now 3.6%, is slightly less than half the 7.5% rate currently used by SamCERA and about one-third less than SamCERA's actual 10-year rate of return of 5.54% (see below).

The Grand Jury requested both the Controller and SamCERA to calculate the effect of these GASB changes on SamCERA's acknowledged unfunded liability. Both declined for a variety of reasons, including that GASB has not yet issued final guidelines for implementation of Statement 68, that an actuarial calculation would be required that is outside of the normal scope of work of the independent actuary, and that GASB Statement 68 is not yet in effect. SamCERA further stated that it believes it will be able to continue using its assumed rate of return, currently 7.5%, in calculating its unfunded liability and will not be required to use the lower rate of return provided in Statement 68.

Lacking a calculation of SamCERA's unfunded liability based upon GASB Statement 68, the Grand Jury looked to other sources for an independent assessment of SamCERA's funding status.

SamCERA's benefits are guaranteed by state law.[37] Studies by the non-partisan Congressional Budget Office and the Center for Retirement Research at Boston College have concluded that a "risk free" rate of return should be used when calculating such a guaranteed pension plan's unfunded liability.[38] As seen below, SamCERA's unfunded liability would be much higher if it used a risk free rate of return in its calculation.

A 2012 Stanford study estimated SamCERA's unfunded liability to be $2.505 billion using the risk free rate of return of 5% applied uniformly.[39] Recall here that SamCERA's 10-year actual rate of return is 5.54%.

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[34] *New GASB Pension Statements to Bring about Major Improvements in Financial Reporting*.

[35] The 20-Bond Index consists of 20 general obligation bonds that mature in 20 years. The average rating of the 20 bonds is roughly equivalent to Moody's Investors Service's Aa2 rating and Standard & Poor's Corp.'s AA. The Bond Buyer, *Bond Buyer Ind*exes, http://www.bondbuyer.com/marketstatistics/search_bbi.html?details=true (January 18, 2013).

[36] The Bond Buyer, *Buyer Bond Indexes*, http://www.bondbuyer.com/apps/custom/msa_search.php?product=bbi_history&col1=1&start_date=01%2F08%2F2012&end_date=01%2F15%2F2013&submit=GO (January 10, 2013).

[37] California Government Code Sections 31450-31485.18.

[38] Congressional Budget Office, *The Underfunding of State and Local Pension Plans*, (May 2011); Alicia H. Munnell, Richard W. Kopcke, Jean-Pierre Aubry, and Laura Quinby, "Valuing Liabilities In State And Local Plans," Center for Retirement Research at Boston College, *State and Local Pension Plans, Number 11, June 2010*.

[39] Stanford Institute of Economic Policy Research, "*MORE PENSION MATH: Funded Status, Benefits, and Spending Trends for California's Largest Independent Public Employee Pension Systems*, http://siepr.stanford.edu/system/files/shared/pubs/papers/pdf/Nation_More_Pension_v09.pdf, (February 21, 2012).

An October 2010 paper by two members of the National Bureau of Economic Research concluded that SamCERA's unfunded liability was $2.5 billion when the discount rate used is the risk free 2009 Treasury yield curve.[40]

A third study reviewed by the Grand Jury analyzed the effect of proposed action by Moody's Investors Service (Moody's), a leading provider of bond rating services. Moody's rates bonds issued by San Mateo County.[41] On July 2, 2012, Moody's announced that it was proposing adjustments to U.S. public pension data.[42] (Appendix B). Among the adjustments proposed by Moody's were the following:

- Accrued actuarial liabilities will be adjusted based on a high-grade long-term corporate bond index discount rate (5.5% for 2010 and 2011)
- Where possible, asset smoothing will be eliminated in favor of market or fair value as of the actuarial reporting date

Moody's is reviewing comments to these adjustments as of the date of this report.

John Dickerson is a financial professional involved in public sector pension analysis and reform. Mr. Dickerson focuses on the impact of unfunded pension debt on the 21 California counties, including the County, which operate independent pension funds.[43] Mr. Dickerson recently assessed the effect of the adjustments Moody's proposes on, among others, SamCERA.[44] He concluded that application of Moody's proposed changes would cause SamCERA's unfunded liability as of June 30, 2011, to be $1.95 billion, not the $842 million it reported as of that date.[45] A more current calculation is not available, but the unfunded liability would be over $2 billion if the currently reported unfunded liability of $962,282,000 had been used in the calculation.

If SamCERA's unfunded liability is actually $2 billion, then:

- Its funded ratio would be approximately 55%

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[40] Robert Novy-Marx (University of Rochester) and Joshua Rauh (Kellogg School of Management), "The Crisis in Local Government Pensions in the United States" (October 2010).

[41] For example, see *MOODY'S ASSIGNS Aaa RATING TO SAN MATEO COUNTY CCD (CA) 2012 GO REFUNDING BONDS; CONCURRENTLY AFFIRMS Aaa RATING TO OUTSTANDING GO BONDS,* http://www.moodys.com/research/MOODYS-ASSIGNS-Aaa-RATING-TO-SAN-MATEO-COUNTY-CCD-CA--PR_243032 (January 18April 10, 20123).

[42] Moody's Investors Service, Moody's proposes adjustments to US public sector pension data, http://www.moodys.com/research/Moodys-proposes-adjustments-to-US-public-sector-pension-data--PR_249988 (January 18, 2013).

[43] California Public Policy Center, http://www.californiapublicpolicycenter.org/the-impact-of-moodys-proposed-changes-in-analyzing-government-pension-data/, (January 18, 213).

[44] John G. Dickerson, *The Impact of Moody's Proposed Changes in Analyzing Government Pension Data*, http://www.californiapublicpolicycenter.org/the-impact-of-moodys-proposed-changes-in-analyzing-government-pension-data/

[45] Dickerson, p. 5.

- The annual amortization payment the County would be required to make to SamCERA could increase to about $185 million per year,[46] roughly 10% of the FY2013 County budget

SamCERA's Assumed and Actual Rates of Return

Effective July 1, 2005, SamCERA reduced its assumed rate of return from 8.00% to 7.75%.[47] On May 22, 2012, SamCERA's Board of Retirement voted unanimously to lower SamCERA's assumed rate of return from 7.75% to 7.5% effective for FY2013.[48] In comparison, as of September 2012, the 100 largest U.S. private pension plans used an average discount rate of 4% in determining their unfunded pension liabilities.[49] For purposes of this analysis, a rate of return assumption and a discount rate assumption are the same. Use of a lower discount rate results in a higher unfunded liability.

If the assumed rate of return is too optimistic, all else being equal, the County's amortization payments to SamCERA for its unfunded liability will rise in the future to make up for a shortfall in the rate of return.[50] County taxpayers, not SamCERA beneficiaries, bear the financial burden of SamCERA's failure to meet its investment expectations through reduced services, higher taxes, or both.

The assumed rate of return is important because the County's payments to amortize the unfunded liability are calculated based upon that rate. According to the Controller, for every 0.25% earned by SamCERA below its assumed rate of return, the County's required contribution to SamCERA attributable solely to the unfunded liability increases by approximately 3% of covered payroll, or about $13 million annually.[51] SamCERA disagrees. According to SamCERA, based upon a more recent valuation of SamCERA's investments, changes in the number of County workers, and other factors, for each 0.25% earned by SamCERA below its assumed rate of return, the County's required contribution to SamCERA attributable solely to the unfunded liability increases by approximately $7.25 million annually.[52]

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[46] This is twice the amount the County budgeted for FY2013 for the acknowledged unfunded liability of $1 billion. Support for this conclusion is provided by the Controller who has stated that for each 0.25% that SamCERA's actual rate of return is less than its assumed rate of return, the County's contribution to SamCERA is increased by $13 million. SamCERA's 10-year actual rate of return, 5.54%, is 7.84 units of 0.25% less than its assumed rate of return of 7.5%. 7.84 units x $13 million = $102 million additional annual contribution for a total required annual contribution of $193 million.

[47] SamCERA Responses.

[48] SamCERA CAFR, p. 13.

[49] Public and private pension plans use a "discount rate" to determine their unfunded liabilities. In the case of SamCERA, the "discount rate" and assumed rate of return are the same. County CAFR, p. iii.

[50] Report of the State Budget Crisis Taskforce, *California Report* (July 17, 2012), p. 21.

[51] County CAFR, p. iv.

[52] SamCERA Responses.

The California Report, which examined, among others, California's pension system, describes three effects of overestimating the rate of return:

> Using a higher-than-appropriate [rate of return] can have at least three effects. First, pension **plans will appear healthier than they otherwise would**, potentially creating incentives to reduce contributions to plans or to enhance benefits. Second, it can **create pressures for pension systems to invest in risky assets in an effort to achieve higher investment returns**…. Third, it **can keep employer contributions artificially low**, until and unless pension systems suffer investment shortfalls. Because these shortfalls often are associated with economic downturns and contribution increases follow shortly thereafter, the contribution increases can occur at the times governments are least able to afford them. [Emphasis added.][53]

Table 3 shows SamCERA's actual rates of return, after deduction of investment costs, for the periods indicated:

Table 3[54]

SamCERA's Actual Rates of Return

	1 Year Ending 6/30/2012	5 Years Ending 6/30/2012	10 Years Ending 6/30/2012
SamCERA Total Fund	-0.41%	0.12%	5.54%

Over the past 10 years, on average, SamCERA's actual rate of return has failed to achieve the assumed rates of return for most of the period, 8.00 % and 7.75%, as well as the recently lowered assumed rate of 7.5%. Specifically, the actual 10-year rate of return, 5.54%, is almost one-third less than the average assumed rate of return for the period.

The following are some reasons why the assumed rate of return adopted from time to time by SamCERA's Board of Retirement has been overstated:[55]

- The assumed rate of return is the same or similar to the assumed rates of return adopted by other public pension plans, many of which have also been overstated

- A lower assumed rate of return would require higher annual payments to amortize the unfunded liability[56]

[53] *California Report,* p. 24

[54] Content sourced from SamCERA Responses.

[55] The minutes of the May 22, 2012, meeting of the Board of Retirement reflect that the impact of lowering the assumed rate of return and other public plans' assumed rates of return were discussed in setting SamCERA's assumed rate of return.

- Higher annual payments by the County to amortize the unfunded liability might draw unwelcomed attention to County employee pensions

SamCERA's Investment Performance

Three factors - aggregate market movement, asset allocation, and specific asset selection - determine the rate of return of an investment portfolio.[57] Clearly, SamCERA does not control market movement. SamCERA's Board of Retirement does, however, determine its allocation among its various asset classes such as domestic equity, fixed income, and commodities. The actual investments are made by independent managers. SamCERA employs an investment consultant (since 2001, Strategic Investment Consultants) which recommends asset managers. The Board of Retirement then selects the managers who invest the assets.

SamCERA's investment performance can be very important to the retirement plan's success. SamCERA estimates that currently about one-half of its $2.3 billion investment portfolio is the result of investment earnings.[58] Interestingly, SamCERA notes in its online Investment Program that "… in a typical pension plan more than 80% of the total cost of benefits will be paid from investment earnings."[59]

How should one judge SamCERA's investment performance? While the recent financial crisis adversely affected all pension funds, how did SamCERA perform relative to other investment funds?

One way to answer that question would be to see how SamCERA's performance compares with that of its peers, 88 public pension plans with total fund sizes in excess of $100 million. SamCERA's percentile ranking among its peer group for each of the periods indicated is set forth in Table 4:

Table 4[60]

SamCERA's Peer Rankings

	1 Year Ending 6/30/2012	5 Years Ending 6/30/2012	10 Years Ending 6/30/2012
SamCERA Total Fund	82	88	83

56 A lower assumed rate of return requires payment of the resulting pension shortfall in one year; amortization of an unfunded liability occurs over fifteen years, thus at a much reduced annual amount, albeit one with, in effect, an interest cost.

57 Roger G. Ibbotson, "The Importance of Asset Allocation," *Financial Analysts Journal. Volume 66 Number 2* (March/April 2010).

58 SamCERA Responses.

59 http://samcera.org/investments.html (February 6, 1013).

60 Content sourced from SamCERA Responses.

These rankings mean that for each of these periods, SamCERA's investment performance was in the bottom 20% of its peer group.

Another measure of performance would be to compare SamCERA's rate of return with that achieved by similar funds. For example, the 69 largest college endowments with assets over $1 billion[61] returned 7.6% over the past 10 years.[62] SamCERA's rate of return for the same period was 5.54%. A 2% difference on $1 billion for 10 years is more than $200 million after taking compounding into consideration.

Yet another measure of performance would be to compare SamCERA's investment results with those that could have been achieved had other investment choices been made.

For comparison purposes, the Grand Jury examined one investment approach SamCERA theoretically could have taken over the past five and ten-year periods. These periods were chosen because SamCERA's asset allocation mix during those periods was generally similar to that of the investment to which it was compared.

The Vanguard Group, Inc., is one of the world's largest investment management companies. It offers mutual funds, exchange traded funds, and other financial products and has approximately $2 trillion under management.[63]

Vanguard's Balanced Income Fund Admiral Shares (VBIAX) "invests roughly 60% in stocks and 40% in bonds by tracking two indexes that represent broad barometers for the U.S. equity and U.S. taxable bond markets." VBIAX is a passively managed, index-based investment.[64] There were three principal differences between SamCERA's actively managed investments and VBIAX during these time periods. First, SamCERA had a target of 10% for investment in real estate.[65] VBIAX does not invest in real estate. Second, the equity portion of SamCERA's investments was globally diversified.[66] VBIAX invests solely in U.S. companies. Third, for FY2012, 13% of SamCERA's portfolio was invested in "alternative investments." VBIAX does not invest in these assets.

Even with these differences, the Grand Jury concluded that a comparison of SamCERA's performance to that of VBIAX would be of interest. Table 5 sets forth that comparison.

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[61] http://en.wikipedia.org/wiki/List_of_colleges_and_universities_in_the_United_States_by_endowment

[62] College Endowments Show Weak Returns, *Wall Street Journal*, February 1, 2013 (http://online.wsj.com/article/SB10001424127887324610504578276360954805602.html?mod=ITP_moneyandinvesting_2&_nocache=1359741546608&user=welcome&mg=id-wsj)

[63] Wikipedia, http://en.wikipedia.org/wiki/The_Vanguard_Group.

[64] The Vanguard Group, Inc., https://personal.vanguard.com/us/funds/snapshot?FundId=0502&FundIntExt=INT.

[65] According to the SamCERA PAFR, p. 4, SamCERA's best performing asset class for 2012 was real estate, up 8.98%. This benefits SamCERA in this comparison.

[66] According to the SamCERA PAFR, SamCERA's portfolio was 18% invested in international equity for 2012.

Table 5[67]

SamCERA vs. Vanguard

Fund	5 Years Ending 6/30/2012	10 Years Ending 6/30/2012
SamCERA Total Fund	Rate of Return: 0.12% Investment Income – (-$11,377,005)[68]	Rate of Return: 5.54% Investment Income: $826,088,643
Vanguard VBIAX	Rate of Return: 3.62% Investment Income: $66,726,282	Rate of Return: 6.29% Investment Income: $937,923,748

How much did SamCERA pay its investment managers for its investment results? Table 6 sets forth SamCERA's investment costs for the past five years:

Table 6[69]

SamCERA Investment Costs

	1 Year Ending 6/30/2012	1 Year Ending 6/30/2011	1 Year Ending 6/30/2010	1 Year Ending 6/30/2009	1 Year Ending 6/30/2008
Dollar Amount	$20,940,955	$15,906,365	$8,380,882	$10,522,665	$10,924,162
Percentage Of Invested Assets	0.90%	0.88%	0.53%	0.52%	0.51%

For the past five years, SamCERA has paid a total of $66,675,029 to investment managers who produced a net return of 0.12% and a loss of -$11,377,005. An investment during that period in VBIAX would have cost approximately $1,789,362 (97% less), produced a net return of 3.62% (30 times higher), and a gain of $66,726,282 ($78,103,287 more).

[67] Content sourced from SamCERA Responses and rate of return information provided by Vanguard.
[68] Although a positive rate of return is shown for this period, a dollar investment loss was incurred. SamCERA explains in a SamCERA Response that this anomaly is created by use of different expenses in calculating the rate of return and the dollar loss.
[69] Content sourced from SamCERA Responses.

Individual members of the Board of Supervisors receive periodic financial information from SamCERA regarding its financial performance. Despite the enormous impact SamCERA's unfunded liability has on the County's finances, however, the Board of Supervisors sitting as such does not formally review SamCERA's financial performance on a regular basis.

Alternative Investments

On August 24, 2010, SamCERA changed its strategic asset allocation strategy from 50% equities, 40% fixed income, and 10% real estate to an allocation of 53% equities, 22% fixed income, 5% real estate, and 20% alternative investments (of which 40% is private equity, 30% risk parity, 15% commodities, and 15% hedge funds[70]). SamCERA states that this change "will potentially bring more robust overall performance going forward."[71]

David Swensen is the chief investment officer of Yale University's endowment fund. He is recognized as a pioneer in the use of alternative investments to improve investment returns. The following statement quoting Mr. Swensen is from the January 31, 2012, edition of online Bloomberg:[72]

> Unless an investor has access to 'incredibly high-qualified professionals,' they 'should be 100 percent passive -- that includes almost all individual investors and most institutional investors….'

Table 7 sets forth the percentile ranking among their peers of each of SamCERA's alternative investment managers for which peer ranking information is available. As with SamCERA's peer rankings, the lower the number, the better.

Table 7[73]

Peer Rankings of SamCERA's Alternative Investment Managers

Manager	Sub-Asset Class	Percentile Ranking One Year	Percentile Ranking Three Years
AQR Delta	Hedge Fund	28	16
SSgA Multisource	Commodities	25	20

70 The Wall Street Journal, January 2, 2013, in an article titled "*Hedge Funds Again Prove a Laggard,"* reported that generally speaking, "hedge funds lagged behind broader markets for the fourth year in a row, the longest period of underperformance since 1998, according to industry tracker HFR." See also, The Economist, *Going Nowhere Fast*, http://www.economist.com/news/finance-and-economics/21568741-hedge-funds-have-had-another-lousy-year-cap-disappointing-decade-going (December 22, 2012).

71 SamCERA Responses.

72 Kelly Bit, "Yale's Swensen: Index Funds Best Plan for Most, *Bloomberg Businessweek*, http://www.bloomberg.com/news/2012-01-31/yale-s-swensen-says-passive-index-funds-best-option-for-most-investors.html, (January 31, 2012).

73 Content sourced from SamCERA Responses.

Manager	Sub-Asset Class	Percentile Ranking One Year	Percentile Ranking Three Years
Active Commodity			
AQR Global Risk Premium Fund	Risk Parity	64	35

None of SamCERA's alternative asset managers for which peer information is available is in the top 10% of its peer group. This raises the question whether they are the "incredibly high-qualified professionals" referred to by Mr. Swensen.

CalPERS has invested significantly in alternative investments for many years, including the last five fiscal years. For example, as of December 5, 2012, the CalPERS investment fund was allocated 18% to alternative investments.[74] Table 8 shows the CalPERS investment results for the past three, five, and ten years compared with those of SamCERA:

Table 8[75]

CalPERS and SamCERA Investment Results

	3 Years Ending 9/30/12	5 Years Ending 9/30/12	10 Years Ending 9/30/12
CalPERS Total Fund	9.3%[76]	0.1%	7.3%
SamCERA Total Fund	9.74%	1.4%	7.3%

This comparison calls into question whether an investment strategy that allocates a significant percentage of the investment portfolio to alternative investments will result in higher returns.

This shift to alternative investments in search of a higher return runs counter to economic theory. In an article published by the Social Science Research Network entitled "Pension Fund Asset Allocation and Liability Discount Rates: Camouflage and Reckless Risk Taking by U.S. Public Plans?" the following conclusion was reached:

[74] CalPERS Facts at a Glance, December 2012. Note that all figures in this table are for time periods that differ from all other time periods used in this report. CalPERS reporting methods caused this change.
[75] Content sourced from SamCERA Responses and CalPERS Facts at a Glance, December 2012.
[76] This return is net of investment fees. All other returns in this table are before deduction of fees.

> U.S. public funds exploit the opaque incentives provided by their distinct regulatory environment and behave very differently from U.S. corporate funds and both public and non-public pension funds in Canada and Europe. In the past two decades, U.S. public funds uniquely increased their allocation to riskier investment strategies in order to maintain high discount rates and present lower liabilities, especially if their proportion of retired members increased more. **In line with economic theory, all other groups of pension funds reduced their allocation to risky assets as they mature, and lowered discount rates as riskless interest rates declined.** [Emphasis added.]

Approaches to the Unfunded Liability Problem

Below are some positive steps of varying effectiveness that the County and SamCERA have taken to address SamCERA's unfunded liability problem:

- **Hiring and Pay Freeze**

County officials state that a wage freeze has been in effect for most County employees for the past four years and will last for approximately two more years. The County estimates about $6 million will have been saved for the period FY2010-2013.[77] For perspective, the County payroll for FY2013 alone is over $406 million. An "on again, off again" hiring freeze has also been in effect during this period. Wage and hiring freezes have a favorable effect on retirement costs and, indirectly, the size of SamCERA's unfunded liability.

- **Reduced Amortization Period**

California law permits SamCERA's unfunded liability to be amortized over a period of 30 years.[78] For many years, SamCERA had a 20-year annually reducing amortization policy. The Board of Retirement in 2008 adopted a policy to amortize the unfunded liability over layered 15-year periods.[79] Like a home mortgage, the shorter the amortization period, the higher the periodic payment, the quicker the unfunded liability is reduced, and the lower the total cost.

The Grand Jury noted that for FY2012, the County contributed $12 million more toward the unfunded liability than was actuarially required.[80]

- **Changes in Retirement Benefits**

In recognition of the increasing cost of pensions, the County on July 12, 2011, made changes in retirement benefits such as reducing benefit formulas for new hires, raising the age requirement for achievement of maximum pension benefits, and reducing the County's pickup of pension cost

[77] County Responses.
[78] California Government Code Section 31453.6.
[79] SamCERA Report, p. 41. Per the SamCERA Responses, the amortization period was once 20 years and would decline by one year each year. When the number of years became too small, the period would be reset to 20 years. The layered 15-year policy solved this problem.
[80] Calculated from SamCERA Responses.

of living adjustment costs (collectively, 2011 Changes).[81] A memorandum dated June 27, 2011, from Donna Vaillancourt, the County's Human Resources Director, to the Board of Supervisors set forth the estimated savings to be achieved from the 2011 Changes (Appendix C.) Table 9 sets forth the best-case scenario for these estimated savings:

Table 9[82]

County Pension Best–Case Cost Savings From 2011 Changes

Category	Year 1 Savings	Year 10 Cumulative Savings	Year 20 Cumulative Savings
General Plan Members	$121,000	$25,448,000	$113,330,000
Organization of Sheriff's Sergeants	$13,000	$1,235,000	$5,676,000
Deputy Sheriff Association	$58,000	$5,393,000	$26,505,000
TOTAL	$192,000.00	$32,076,000.00	$145,511,000.00

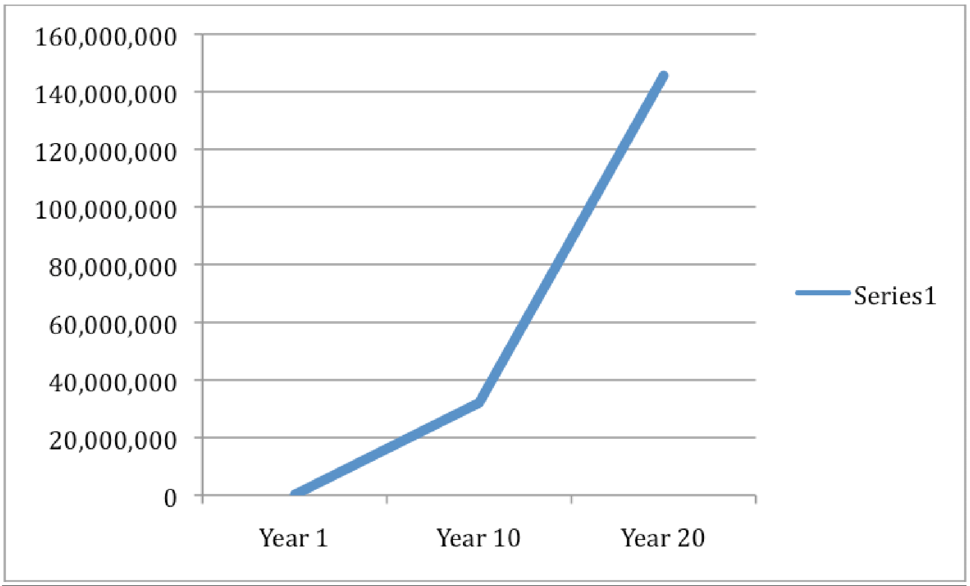
The estimated best-case total cost savings to the County as a result of the 2011 Changes was $145,511,000 over 20 years. As seen in Graph 1 below, most of these savings were back-loaded:

[81] Board of Supervisors Minutes of July 12, 2011, Meeting

[82] Content sourced from Inter-Department Correspondence from Donna Vaillancourt, County Human Resource Director, to the Board of Supervisors regarding Actuarial Valuation of Retirement Benefit Changes for New General and Safety Plan Members (June 27, 2011).

Graph 1

County Pension Cost Savings From 2011 Changes



To put these pension savings into perspective, the Grand Jury asked SamCERA to calculate their present value. (The Board of Supervisors did not request and was not supplied with a present value calculation of the estimated pension savings.)

In order to calculate the present value of future savings, a discount rate is used. The discount rate reflects the time value of money, i.e., a dollar today is worth more than a dollar at some point in the future. A discount rate of 5.125% was used in calculating the present value of these expected savings. This discount rate was chosen because that is the anticipated interest rate for the bond issue for the proposed new jail.[83] If the County actually had the pension cost savings now, it could theoretically reduce the size of the jail bond issue, thereby saving the 5.125% interest cost on the funds not borrowed.

The present value of the anticipated pension cost savings from the 2011 Changes was approximately $77 million.[84] The 2011 Changes did not adequately address SamCERA's unfunded liability problem because they:

- Pay for only about one year's "interest" on SamCERA's acknowledged unfunded liability, assuming SamCERA can, in fact, earn its assumed rate of return of 7.5%
- Represent less than the amount that SamCERA's acknowledged unfunded liability has grown, on average, for each of the past 12 years

[83] County Responses.
[84] SamCERA Responses.

California's Public Employees' Pension Reform Act of 2013 (PEPRA), effective January 1, 2013, primarily affects County employees hired after January 1, 2013, and will substantially supplant the 2011 Changes over time.[85] Employees hired after January 1, 2013, will be covered either by the 2011 Changes or PEPRA, depending on their past employment history. The County estimates that the pension savings under PEPRA will not be significantly higher than those under the 2011 Changes.

- **Use of Measure A Sales Tax and Other Revenue Sources**

The Controller discussed possible additional efforts to reduce SamCERA's unfunded liability in the County CAFR. He stated that the County could use excess Educational Revenue Augmentation Fund monies, Measure A revenues, and other "unanticipated discretionary revenues" to increase payments to SamCERA. He gave the example of the County paying an additional $40 million annually to SamCERA for five years, which would have the effect of reducing the annual payment to SamCERA by approximately $17 million per year thereafter. He notes that such a payment would have the same impact as decreasing the assumed rate of return by 0.75% to 6.75%.

As of the issuance of this report, there appears to be little sentiment on the Board of Supervisors for using Measure A funds to pay down SamCERA's unfunded liability. For example, neither the resolution proposing the sales tax increase to San Mateo County voters nor the "Argument in Favor of Measure A" contained in the November 6, 2012, Sample Ballot Official Voter Information Pamphlet mentioned SamCERA's unfunded liability as a possible use of these new tax revenues. A November 13, 2012, article in The Daily Journal entitled, "County figuring out how to spend new tax money," quoted three members of the Board of Supervisors regarding their thoughts on suitable uses for the new sales tax revenues. SamCERA's unfunded liability was not mentioned.

By Inter-Departmental Correspondence dated January 8, 2013, County Manager John Maltbie suggested that the Board of Supervisors could use Measure A funds to pay down SamCERA's unfunded liability. As of its February 12, 2013, meeting on the use of Measure A revenues, there continued to be little support voiced by the Board of Supervisors for using Measure A funds to pay down SamCERA's unfunded liability.[86] However, according to a memorandum dated March 11, 2013, from County Manager John Maltbie, the Board of Supervisors at its meeting on June 18, 2013, will consider use of Measure A funds to reduce pension unfunded liabilities.

- **Pension Obligation Bonds**

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[85] County employees hired between the effective dates of the 2011 County pension changes and January 1, 2013, will continue to be governed by the 2011 County changes.

[86] Michelle Durand, "Taxing decisions: County officials, public tackle sales tax priorities," *The Daily Journal*, February 13, 2013 (http://www.smdailyjournal.com/article_preview.php?id=1763131&title=Taxing%20decisions:%20County%20officials,%20public%20tackle%20sales%20tax%20priorities); Bonnie Eslinger, "San Mateo County supervisors mull how to slice up Measure A pie," *Mercury News*, February 13, 2013 (http://www.mercurynews.com/peninsula/ci_22577997/san-mateo-county-supervisors-mull-how-slice-up).

One alternative available to reduce SamCERA's unfunded liability would be for the County to issue pension obligation bonds (POBs). Under this scenario, the County would issue interest bearing bonds the proceeds of which would be contributed to SamCERA for investment. The Controller discussed POBs in the County CAFR:

> These POB liabilities [issued by others] are being repaid, with interest, but are not included in the calculation of unfunded pension liabilities. Additionally, **many of the assets purchased by pension plans from the proceeds of these POBs lost significant value in the Great Recession**. Now many of these entities that issued POBs have not only large unfunded pension liabilities but also must pay off these bonds. Fortunately, the County never issued POBs and is therefore not in this position. [Emphasis added.][87]

SamCERA assumes that it will earn 7.5% on its investments. If this proves to be correct, to the extent the unfunded liability is not reduced, there is a lost opportunity cost equal to what SamCERA would have earned on the "missing" money. For example, if the County made an "extraordinary" contribution of $200 million to SamCERA toward the unfunded liability, funded by issuance of POBs,[88] SamCERA would theoretically earn $15 million on that money the first year, $16.2 million the second year, etc. The County must make up for these "missing earnings" by later making additional unfunded liability payments. The cost to the County of delaying contributions to reduce the unfunded liability is equal to the amount SamCERA would have earned if it had the money to invest.

What is the case in favor of POBs? If the interest rate for POBs is less than SamCERA's earnings, then the interest differential is a savings to the County. Assuming a 5.125% interest rate for POBs[89] and a SamCERA earnings rate of 7.5%, the savings to the County the first year from issuance of $200 million in POBs would be 2.375% x $200 million = $4.75 million.

There are several reasons why the County may decide not to issue POBs. One may be that it chooses to use its borrowing power for other purposes, e.g., construction of a new jail. Another, as implied by the Controller, is that the County is concerned that SamCERA will not, in fact, meet its earnings assumption.

- **Pension Reform**

On June 5, 2012, City of San Jose voters approved a ballot initiative that modified pensions for future hires and current employees. A fact sheet regarding the initiative is attached as Appendix D. Of note here, current employees have the choice of two options. Per the fact sheet, Option 1 included the following provision:

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[87] County CAFR, p. iv.

[88] This example is for illustration purposes only and does not take into consideration the County's debt service limit issue.

[89] Per the County Responses, the County anticipates that the interest rate will be 5.125 % on the bonds it expects to issue for construction of its new jail. Inter-Departmental Correspondence from John L. Maltbie, County Manager, to the Board of Supervisors regarding the Replacement Jail Project Financing Plan (October 1, 2012).

> Employees contribute an additional 4% of their salary (starting in June 2013) to help pay off the pension plan's unfunded liabilities. These extra contributions could increase by an additional 4% per year until they cover 1/2 of the cost of paying off the unfunded liability or reach a cap of 16%.

Option 2 was "a more modest retirement plan for their remaining years on the job."

If the County adopted a plan similar to San Jose's, under Option 1, County employees would participate in paying up to one-half of SamCERA's unfunded liability. This could result in a savings to County taxpayers of hundreds of millions of dollars.

This San Jose pension reform plan has been challenged in court.

A Note About SamCERA's Financial Reporting

In an effort to make its finances more easily understood by the general public, SamCERA annually publishes the SamCERA PAFR, known as the Popular Annual Financial Report. SamCERA has received the Government Finance Officers Association Award for Outstanding Achievement in Popular Annual Financial Reporting for the past nine years.[90]

Even though it has received this favorable recognition, a reader would not learn the following facts from the SamCERA PAFR:

- For FY2012, SamCERA's investments had a negative investment return of -0.41 and lost over $11 million after paying investment costs.
- SamCERA's investment returns have been in the lowest 20% of its peer group for the past one, five, and ten-year periods.
- On average, SamCERA's actual rate of return has not achieved its assumed rate of return over the past one, five, and ten-year periods.
- SamCERA acknowledges a current unfunded liability of almost $1 billion on a "smoothed" basis.
- The County contributed $103,948,470 to SamCERA attributable solely to its unfunded liability.

Separately, the Grand Jury noted that CalPERS "Facts at a Glance," available online at https://www.calpers.ca.gov/index.jsp?bc=/about/facts/home.xml, provides information that is useful to both the public and CalPERS beneficiaries. While SamCERA currently provides some of the same information online, "Facts at a Glance" provides considerable additional useful information in an easy-to-use format.

[90] The most recent awards were for the fiscal year ended June 30, 2011. SamCERA PAFR.

Coda

After this report was completed, SamCERA advised the Grand Jury that it had received favorable recognition from two sources. First, it was nominated by Money Management Intelligence for (but did not win) Small Plan of the Year.[91] Second, Rick Roeder, of the actuarial firm Gabriel Roeder Smith,[92] ranked SamCERA third most conservative of 37 California public pension systems.[93]

While this is good news, the Grand Jury concludes that this recognition says more about the unfortunate state of affairs of California public pension plans than it does about SamCERA.

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.

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.

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.

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.

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

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

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.

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.

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.

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[91] http://www.moneymanagementintelligence.com/Article/3137141/Community-Awards2/Small-Public-Plan-Of-The-Year-Nominees.html

[92] http://www.gabrielroeder.com

[93] Roeder Financial, California Pension Systems: Ranking their Funding Assumptions (March 15, 2013)

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.

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.

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

RECOMMENDATIONS

The Grand Jury recommends that ***SamCERA's Board of Retirement*** do the following:

R1. Adopt a policy to reduce SamCERA's assumed rate of return by 0.25% per year until such time as it has achieved a funded ratio of 90%.

R2. Once a funded ratio of 90% has been achieved, establish SamCERA's assumed rate of return each year by taking into consideration the guaranteed nature of its participants' benefits and relevant macro-economic factors while disregarding (i) the effect, if any, the assumed rate of return will have on required contributions to SamCERA and (ii) the assumed rates of return of other public pension funds.

R3. Include in the SamCERA CAFR and SamCERA PAFR, the following information in tabular form:

   a. For each of the past one, three, five, and ten fiscal years:

      i. Its annual investment earnings (or losses) stated as a percentage and in dollars, both net of investment costs

      ii. Its actual rates of return as compared with its assumed rates of return

      iii. Its peer rankings

      iv. The peer rankings of each of its investment managers for which such rankings are available

   b. The unfunded liability amount for each of the past 10 years

   c. The amount contributed by the County to SamCERA attributable solely to its unfunded liability for each of the past 10 years

   d. The number of beneficiaries receiving annual benefits for each of the past five years in the following amounts:

      i. \$100,000 - \$149,999

      ii. \$150,000 - \$199,999

      iii. \$200,000 and up

   e. The average and median annual benefit paid to SamCERA beneficiaries for the past five years

R4. Replicate on SamCERA's website, modified to apply to SamCERA, CalPERS "Facts at a Glance."

R5. Employ only investment managers for its alternative assets that rank in the top 10% of their peer group for at least the past five years.

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

R6. Implement GASB Statement 68 for FY2014.

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

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

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.

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

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.

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%.

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

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.

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.

REQUEST FOR RESPONSES

Pursuant to Penal Code Section 933.05, the Grand Jury requests the following to respond to the foregoing Findings and Recommendations, referring in such responses to the number thereof:

- County Board of Supervisors
- SamCERA Board of Retirement

The governing bodies indicated above should be aware that the comment or response of the governing body must be conducted subject to the notice, agenda, and open meeting requirements of the Brown Act.

DISCLAIMER

This report is issued by the Grand Jury with the exception of three members who, directly or indirectly, are or may be SamCERA beneficiaries. These Grand Jurors were excluded from all parts of the Grand Jury's investigation and the making and acceptance of this report. This report is based on information from outside sources with none of the information being obtained from the excluded Grand Jurors.

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APPENDIX A

New GASB Pension Statements to Bring about Major Improvements in Financial Reporting

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APPENDIX D

San Jose Pension Reform Ballot Measure Fact Sheet

APPENDIX A

GASB

Governmental Accounting Standards Board
of the Financial Accounting Foundation

June 2012

New GASB Pension Statements to Bring about Major Improvements in Financial Reporting

In June 2012, the GASB approved a pair of related Statements that reflect substantial improvements to the accounting and financial reporting of pensions by state and local governments and pension plans. Statement No. 67, *Financial Reporting for Pension Plans,* addresses financial reporting for state and local government pension plans. Statement No. 68, *Accounting and Financial Reporting for Pensions*, establishes new accounting and financial reporting requirements for governments that provide their employees with pensions.

The guidance contained in these Statements will change how governments calculate and report the costs and obligations associated with pensions in important ways. It is designed to improve the decision-usefulness of reported pension information and to increase the transparency, consistency, and comparability of pension information across governments.

Statement 67 replaces the requirements of Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, for most public employee pension plans. Statement 68 replaces the requirements of Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, for most government employers. The new Statements also replace the requirements of Statement No. 50, *Pension Disclosures*, for those governments and pension plans.

Background

To ensure that GASB pronouncements continue to be of high quality and are in sync with the continuously evolving government environment, the GASB periodically reexamines its standards. Reexamination typically takes place after a Statement has been in place and fully implemented for at least five years. Research on the GASB's pension standards indicated opportunities for significant improvement.

Governments provide pension benefits through various types of *defined benefit* pension plans, which specify the *amount of benefits* to be provided to the employees after the end of their employment. *Single-employer* pension plans provide pension benefits to the employees of one employer (a *single employer*). *Multiple-employer* pension plans provide pension benefits to the employees of more than one employer. Under an *agent* multiple-employer pension plan, the assets of a multiple-employer pension plan are pooled for investment purposes but separate "accounts" are maintained for each individual *agent employer*, so that each agent employer's share of the pooled assets is legally available to pay the pensions of only its employees. In a *cost-sharing* multiple-employer pension plan, *cost-sharing employers* share their assets *and* their obligations to provide pension benefits to their employees—plan assets can be used to pay the pensions of the employees of any employer that provides pensions through the plan. The new Statements address all of these types of plans, as well as *defined contribution* plans, which stipulate the amount to be contributed to employee accounts each year, not the amount of benefits that will be paid in the future.

The Statements apply specifically to governments and pension plans in which a government's contributions to the trust used to administer a pension plan are (a) irrevocable, (b) restricted to paying pension benefits, and (c) are beyond the reach of creditors. Pension benefits provided through trusts that do not meet those three criteria are not addressed in these new Statements and those pension benefits would continue to be accounted for and reported following Statements 25, 27, and 50.

It is important to note that the new Statements relate to *accounting and financial reporting* issues only—how pension costs and obligations are measured and reported in audited external financial reports. The Statements do not address how governments approach pension plan *funding*—a government's policy regarding how much money it will contribute to its pension plan each year. While there has been a close relationship between how governments fund pensions and how they account for and report information about them until now, the new guidance establishes a decided shift from the *funding-based* approach to an *accounting-based* approach. The Board crafted its new Statements with the fundamental belief that funding is squarely a policy decision for elected officials to make as part of the government budget approval process.

Reporting by Governments in Defined Benefit Plans

Recognizing a Liability Related to Pension Promises for Single and Agent Employers

State and local government employees often earn two types of compensation in return for their efforts—current compensation and deferred compensation. Salaries and other forms of current compensation reflected in the paycheck are received by employees during their employment. On the other hand, deferred compensation, including pension benefits, is not received until after the employee's tenure with the government has concluded and vesting and age requirements have been met.

Nevertheless, a government has a present obligation to pay these deferred benefits in the future—a *total pension liability*—once they have been earned. When the total pension liability exceeds the pension plan's net assets (now referred to as plan net position) available for paying benefits, there is a *net pension liability*. Governments will now be required to report that amount as a liability in their accrual-based financial statements (for example, the government-wide statement of net position). The pension plan's net position available for paying benefits is to be measured using the same valuation methods that are used by the pension plan for purposes of preparing its financial statements, including measuring investments at fair value.

This is an important change that will more clearly depict the government's financial position. While this information will, in some cases, give the appearance that a government is financially weaker than it was previously, the financial reality of the government's situation will not have changed. Reporting the net pension liability (or asset, if plan net position exceeds the total pension liability) on the face of the financial statements will more clearly portray the government's financial status because the pension liability will be placed on an equal footing with other long-term obligations.

Measuring the Pension Liability

The new pension standards reflect several changes from those currently in place regarding how governments calculate their total pension liability. The measurement process detailed in the new standards involves three essential steps:

1. Projecting future benefit payments for current and former employees and their beneficiaries

2. Discounting those payments to their present value

3. Allocating the present value over past, present, and future periods of employee service.

The standards continue the general existing practice of incorporating expectations of future employment-related events into projections of pension benefit payments—like projected salary increases and projected years of service—if they affect the amount of pension payments employees will receive. Provisions for automatic cost-of-living adjustments (COLAs) and other automatic benefit changes (which generally are written into the pension benefit terms) will also continue to be included in projections. On the other hand, *ad hoc* COLAs and other ad hoc benefit changes—which are made at the discretion of the government—will only be included in projections if they occur with such regularity that they are effectively automatic.

To discount projected pension benefit payments to a present value, governments assume a *discount rate*. Standards now in effect require governments to apply a discount rate equal to the long-term expected rate of return on the investments of the pension plan. The long-term expected rate of return will continue to be the starting point for the discount rate. However, the new standard makes it clear that this rate should be applied only to available pension plan assets that are expected to be invested using a strategy to achieve that return.

To the extent that a pension plan's net position and projected contributions associated with active and inactive employees, including retirees, is expected to fully cover projected benefit payments for those individuals, the long-term expected rate of return will be used. If there comes a point in the projections when plan net position and contributions related to active and inactive employees is no longer projected to be greater than or equal to projected benefit payments related to those employees and administrative expenses, then from that point forward a government would be required to discount the projected benefit payments using a municipal borrowing rate—a tax-exempt, high-quality (an average rating of AA/Aa or higher, including equivalent ratings) 20-year general obligation bond index rate.

Finally, benefit payments—discounted to their present value—are allocated to past, current, and future periods. The new standards require all governments to use the entry age actuarial cost method to allocate present value, and to do so as a level percentage of payroll. Under this method, the present value of projected benefits is attributed to employees' expected periods of employment starting from when employees first begin to earn benefits.

Calculating Pension Expense

A government's net pension liability varies from year to year for a variety of reasons, including actual earnings on plan investments, employee compensation changes, interest on the outstanding pension liability, contributions from employers and employees, and actual economic or demographic changes not matching up with assumptions made in the actuarial calculations. When these period-to-period changes should be included in the calculation of the cost of a government's operations—as expenses in the accrual-based financial statements—is a key issue.

The new standards will better align the recognition of pension expense with the period in which the related benefits are earned. Considered in total, the changes set forth by the GASB will have the overall effect of expense recognition being accelerated. Under the new standards, several causes of change in the net pension liability will be factored into the calculation of pension expense *immediately* in the period in which the change occurs:

1. Benefits earned each year
2. Interest on the total pension liability
3. Changes in benefit terms
4. Projected earnings on plan investments
5. Changes in plan net position from other than investments

The effects on the total pension liability of (a) changes in assumptions and (b) differences between assumptions and actual experience are to be recognized initially as deferred outflows of resources or deferred inflows of resources and then introduced into the expense calculation systematically and rationally over the average remaining years of employment of employees (active employees and inactive employees, including retirees). This period is likely to be significantly shorter than the period of up to 30 years over which governments may now recognize portions of their pension expense.

The difference between the expected earnings on plan investments and actual investment earnings is to be recognized as deferred outflows of resources or deferred inflows of resources and included in expense in a systematic and rational manner over a five-year closed period rather than longer periods that are allowed under the current standards.

Reporting by Governments in Cost-Sharing Multiple-Employer Plans

Under the pension standards now in effect, cost-sharing employers have not been required to present actuarial information about pensions. Instead, information has been required to be presented in the pension plan's own financial statements for all of the participating governments combined.

Through its research, the GASB concluded that the needs of users of information regarding cost-sharing employers do not differ significantly from those interested in single and agent employers. Therefore, the GASB believes it is important to give users of the financial statements of cost-sharing employers access to better, more transparent financial information. Consequently, under the new standards the GASB is requiring that cost-sharing governments report a net pension liability, pension expense, and pension-related deferred inflows and outflows of resources based on their proportionate share of the collective amounts for all the governments in the plan.

Note Disclosures and Required Supplementary Information

The new standards contain requirements for disclosing information in the notes to the financial statements and presenting required supplementary information (RSI) following the notes. Due to the complexity of the array of pension plan features, the Board concluded it was critical that financial statement users have access to certain basic plan information through governments' own financial statements. The Board believes that including this information will enhance the usefulness of financial reports for both decision making and assessing accountability.

All governments participating in a defined benefit pension plan will now include the following information in their note disclosures:

- Descriptions of the plan and benefits provided
- Significant assumptions employed in the measurement of the net pension liability
- Descriptions of benefit changes and changes in assumptions
- Assumptions related to the discount rate and the impact on the total pension liability of a 1 percentage point increase and decrease in the discount rate
- Net pension liability and deferred outflows of resources and deferred inflows of resources.

Single and agent governments also will be required to disclose, for the current period, the beginning and ending balances of the net pension liability, and the effects of changes during the period (such as the effects of service cost, benefit changes, and actual investment earnings).

Single and agent governments will be required to present RSI schedules with the following information for each of the past 10 years (generally on a prospective basis):

- The beginning and ending balances of the total pension liability, the plan trust's net position, and the net pension liability, and their components
- Total pension liability, the plan's net position, the net pension liability, a ratio of the plan's net position to the total pension liability, the covered-employee payroll, and a ratio of the net pension liability as a percentage of the covered-employee payroll.

If a single, agent, or cost-sharing government has an actuarially determined annual pension contribution (or, if not actuarially determined, then the statutorily determined contribution), it is also required to present an RSI schedule with the following information for each of the past 10 years (generally on a prospective basis): (1) the actuarially determined annual pension contribution (or, if not actuarially determined, then the statutorily determined contribution), (2) the amount of employer contribution actually made, (3) the difference between 1 and 2, (4) the payroll of employees covered by the plan, and (5) a ratio of 2 divided by 4.

Governments are also now required to present notes to the RSI schedules regarding factors that significantly affect the trends in the schedules. For single and agent employers, significant assumptions also should be disclosed.

Special Funding Situations

Special funding situations are circumstances in which (a) a *nonemployer contributing entity* (such as a state government) is legally responsible for contributions directly to a pension plan that is used to provide pensions to the employees of another government (such as school districts located within that state) and (b) one or both of the following is true:

1. The nonemployer is the only entity with a legal obligation to make contributions directly to the plan

2. The amount of the contributions for which the nonemployer is legally responsible is not dependent upon one or more events unrelated to the pensions.

In a special funding situation, the nonemployer has essentially assumed a portion of the employer entity's pension obligation as its own. Consequently, if the nonemployer is a government, it will recognize its proportionate share of the net pension liability, pension expense, and deferred outflows of resources and deferred inflows of resources related to the employer's pensions in its own financial statements.

The government benefitting from the nonemployer's contributions in a special funding situation will calculate its net pension liability, pension expense, and deferred outflows of resources and deferred inflows of resources related to pensions prior to the nonemployer government's support, but would *recognize* in its financial statements only its proportionate share.

Reporting by Governments in Defined Contribution Plans

As previously noted, defined *contribution* plans stipulate the *amount to be contributed to an employee's account* each year, and not the amount of benefits employees will receive after the end of their employment. The new standards generally carry forward the existing requirements regarding defined contribution pensions. Governments will report an expense equal to the amount they are required to contribute for employee service each year and a liability equal to the difference between that required contribution and what the government actually contributes. Governments will also make descriptive disclosures about the plan and its terms, and the method by which contributions to the plan are determined.

Reporting by Pension Plans

Statement No. 67 on plan reporting details guidance for financial reporting by *defined benefit pension plans* administered through trusts that meet the criteria described earlier. This guidance generally carries forward the present framework for the separately issued financial reports of defined benefit pension plans. Statement 67 will significantly improve related financial reporting through enhanced note disclosures and new RSI schedules. The Statement also details note disclosure requirements for *defined contribution pension plans* administered through trusts that meet the criteria.

Effective Dates

Statement No. 67 will take effect for pension plans in fiscal years beginning after June 15, 2013 (that is, for years ended June 30, 2014 or later). Statement No.68 will take effect for employers and governmental nonemployer contributing entities in fiscal years beginning after June 15, 2014 (that is, for years ended June 30, 2015 or later). However, the GASB encourages plans and governments to implement the new standards earlier.

Obtaining the New Statements

The new Statements should be available in early August to download free from the GASB website (www.gasb.org) or to purchase in printed form.

- Order a printed copy of Statement 67
- Order a printed copy of Statement 68
- Read the news release

APPENDIX B

Announcement: **Moody's proposes adjustments to US public sector pension data**

Global Credit Research - 02 Jul 2012

New York, July 02, 2012 -- Moody's Investors Service is requesting comment from market participants on its plan to implement several adjustments to pension liability, asset, and cost information reported by US state and local governments and their pension plans.

Moody's expects the proposed pension adjustments to result in rating actions for local governments where the effect is outsized relative to their rating category, but no state rating changes are expected solely as a result of pursuing the adjustments now under consideration.

"Pension liabilities are widely acknowledged to be understated," said Moody's Managing Director Timothy Blake, who teamed with Vice President and Senior Analyst Marcia Van Wagner on a report outlining the rating agency's plans, "Adjustments to US State and Local Government Reported Pension Data."

"Our proposed adjustments will improve the comparability and transparency of pension information across governments, enhancing our approach to rating state and local government debt," said Blake. "These adjustments build on our current approach to rating state and local government debt that includes an analysis of pension obligations based on reported data and examination of key underlying assumptions."

Growth of reported unfunded pension liabilities over the past decade and the associated budgetary burden of pension contributions have increased the importance of pensions to state and local government credit, according to Moody's, which treats pension liabilities similar to debt in order to better analyze the long-term liabilities of government entities.

Moody's-adjusted fiscal 2010 state and local unfunded pension liabilities total more than $2 trillion -- about three times the total reported by governments.

"Moody's view on pension-related exposure has been reflected in a number of recent downgrades and negative outlooks, including for the states of Illinois, New Jersey and Rhode Island, and the cities of Chicago and Providence," said Blake.

With its data collection now completed for 8,500 local governments and over 14,000 individual pension plans, the rating agency plans four principal adjustments to reported pension information, including:

-- Multiple-employer cost-sharing plan liabilities will be allocated to specific government employers based on proportionate shares of total plan contributions;

-- Accrued actuarial liabilities will be adjusted based on a high-grade long-term corporate bond index discount rate (5.5% for 2010 and 2011);

-- Where possible, asset smoothing will be eliminated in favor of market or fair value as of the actuarial reporting date;

-- Annual pension contributions will be adjusted to reflect the foregoing changes as well as a common amortization period.

"Although Moody's has actively monitored pension pressures, the cost-sharing plan adjustments may change our view of the long-term pension liabilities facing certain local governments," said Van Wagner. "New data regarding sector medians and averages may reveal some unexpected outliers."

The overall expected effect on ratings would reflect the fact that pensions are only one of several factors in the agency's rating methodology.

Moody's invites market participants to provide feedback on its proposal by sending comments by August 31 to cpc@moodys.com.

Moody's subscribers can access the report at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_PBM143254.

* * * * *

NOTE TO JOURNALISTS ONLY: For more information, please call one of our global press information hotlines: New York +1-212-553-0376, London +44-20-7772-5456, Tokyo +813-5408-4110, Hong Kong +852-3758-1350, Sydney +61-2-9270-8141, Mexico City 001-888-779-5833, São Paulo 0800-891-2518, or Buenos Aires 0800-666-3506.

Marcia J Van Wagner
Vice President - Senior Analyst
Public Finance Group
Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
U.S.A.
JOURNALISTS: 212-553-0376
SUBSCRIBERS: 212-553-1653

Timothy Blake
Senior Vice President
Public Finance Group
JOURNALISTS: 212-553-0376
SUBSCRIBERS: 212-553-1653

Releasing Office:
Moody's Investors Service, Inc.
250 Greenwich Street

APPENDIX C

COUNTY OF SAN MATEO

Inter-Departmental Correspondence

Human Resources Department

DATE: June 27, 2011
BOARD MEETING DATE: July 12, 2011
SPECIAL NOTICE/HEARING: None
VOTE REQUIRED: Majority

TO: Honorable Board of Supervisors
FROM: Donna Vaillancourt, Human Resources Director

Peter Bassett, Benefits Manager

SUBJECT: Actuarial Valuation of Retirement Benefit Changes for New General and Safety Plan Members

RECOMMENDATION:

Accept actuarial valuation of cost savings to implement retirement benefit changes for new General and Safety Plan members.

BACKGROUND:

Agreements have been reached with all bargaining groups which change retirement benefits for new hires.

Government Code Section 7507(b)(2) requires that the Board, when considering changes in retirement benefits, shall secure the services of an actuary to provide a statement of the actuarial impact upon future annual costs, including normal cost and any additional accrued liability, before authorizing changes in public retirement plan benefits or other postemployment benefits.

DISCUSSION:

The current Plan 4 benefit for existing General Plan Members is 2%@55.5. Under the new agreements, General Plan Members hired on or after August 7, 2011 will not receive that benefit but instead will receive 1.725%@58. Employees in this plan will not pay the current cost share contribution, but will pay a share of the COLA cost. New General Plan members will continue to have the option of enrolling in Plan 3, the non-contributory plan.

Deputy Sheriff Association (DSA) has agreed to a different retirement benefit for new hires that requires enactment of legislation (with a tentative effective date of January 1, 2012).

The current Plan 4 benefit for existing Safety Plan Members is 3%@50. Under the new agreement with DSA, new DSA members hired on or after January 8, 2012 will not receive that benefit but instead will receive 3%@55. Under this option, new DSA members will pay the current cost share contribution as well as a share of the COLA cost. New DSA members will continue to have the option of enrolling in Plan 3, the non-contributory plan.

Under the new agreement with OSS, new OSS members hired on or after January 8, 2012 will not receive the 3%@50 benefit, but will instead have the option of enrolling in one of two other retirement plans: 2%@50 or 3%@55. Members choosing the latter formula will pay an additional cost share contribution. Under both options, new OSS members will pay a share of the COLA cost. New OSS members will continue to have the option of enrolling in Plan 3, the non-contributory plan

The above-described changes constitute reductions in benefits for new hires. Based on a review by Milliman Inc., the actuarial impact of this benefit change is noted in the table below. Given that it is not possible to estimate which retirement plan option new OSS hires will choose, savings for both options are provided. However, it is important to note that the difference in cost savings between the 2%@50 and 3%@55 with cost-share is actuarially very similar.

Cost Savings for New General Plan as compared to 2%@55.5

1.725%@58

Y1 Savings: $121,000

Y10 Cumulative Savings: $25,448,000

Y20 Cumulative Savings: $113,330,000

Cost Savings for New Safety Plans for OSS as compared to current 3%@50

2%@50	Y1 Savings: $13,000
	Y10 Cumulative Savings: $1,233,000
	Y20 Cumulative Savings: $5,671,000
3%@55	Y1 Savings: $13,000
	Y10 Cumulative Savings: $1,235,000
	Y20 Cumulative Savings: $5,676,000

Cost Savings for New Safety Plan for DSA as compared to current 3%@50

3%@55	Y1 Savings: $58,000
	Y10 Cumulative Savings: $5,393,000
	Y20 Cumulative Savings: $26,505,000

Pursuant to Government Code §7507(c), the actuarial certification of the cost savings to implement the retirement benefit change is being presented for your acceptance at least two weeks prior to implementation of the change.

Accepting this report contributes to Shared Vision 2025 of a Prosperous Community by helping to meet current budget challenges.

FISCAL IMPACT:

There is no fiscal impact in accepting the actuarial valuation. The fiscal impact in making the retirement change is reflected above.

APPENDIX D

CITY OF SAN JOSE CAPITAL OF SILICON VALLEY

Office of Mayor Chuck Reed

Pension Reform Ballot Measure Fact Sheet

On June 5, 2012, San Jose voters approved a pension reform ballot measure with nearly 70% of the vote. The measure was placed on the ballot by Mayor Reed and a majority of the City Council in order to control skyrocketing retirement costs, restore services to the community, and protect the long-term health of the retirement plans. Listed here are key elements of the ballot measure:

New Employees will be placed in a new, lower-cost retirement plan

- New employees will pay 50% of the plan's total cost *(employees currently pay about 1/4 of the cost)*.
- Any *defined benefit component* will have to meet the following requirements:
    - Retirement Age: 60 for public safety employees and 65 for all others. (employees would have the option to retire earlier with reduced benefits)
    - Accrual Rate: could not exceed 2% (of salary) per year of service, with a 65% maximum benefit.
    - Benefit would be based on the highest average salary over a 3-year period.
    - Cost-of-Living-Adjustments: based on CPI, capped at 1.5% per year.
- The City can also contribute to a *defined contribution plan* as long as the City's total cost for the retirement benefits does not exceed 9% of an employee's base salary

Current employees will retain benefits earned and accrued to date under the existing pension plans. *Going forward*, they will have the option to either: a) pay more to keep their current plan, or b) choose a new, lower-cost plan

- *Option 1*: Employees contribute an additional 4% of their salary (starting in June 2013) to help pay off the pension plan's unfunded liabilities. These extra contributions could increase by an additional 4% per year until they cover 1/2 of the cost of paying off the unfunded liability or reach a cap of 16%.
- *Option 2*: Employees switch to a more modest retirement plan for their remaining years on the job:
    - Retirement Age: 57 for public safety employees and 62 for all others (increase would be phased in over 14 years; employees would have the option to retire earlier with reduced benefits).
    - Accrual Rate: 2.0% (of salary) per year, for future years of service.
    - Benefit would be based on the highest average salary over a 3-year period.
    - Cost-of-Living-Adjustments: based on CPI, capped at 1.5% per year.

The City Council will have the ability to temporarily suspend retiree Cost of Living Adjustments (COLAs) during a fiscal and service level emergency

- If the City Council declares a fiscal and service level emergency, it will have the ability to suspend the guaranteed 3% COLA for up to 5 years (*Retirees' pension payments would not be reduced)*.

Disability retirement rules will be reformed to prevent abuses

- Determinations of disability will be made by an independent panel of medical experts.
- The City may provide matching funds for disability insurance for employees who do not qualify for disability retirement but incur lost wages.

"Bonus" Pension Checks from the Supplemental Retiree Benefit Reserve will be discontinued

The City Council will be prohibited from enhancing retirement benefits without voter approval

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