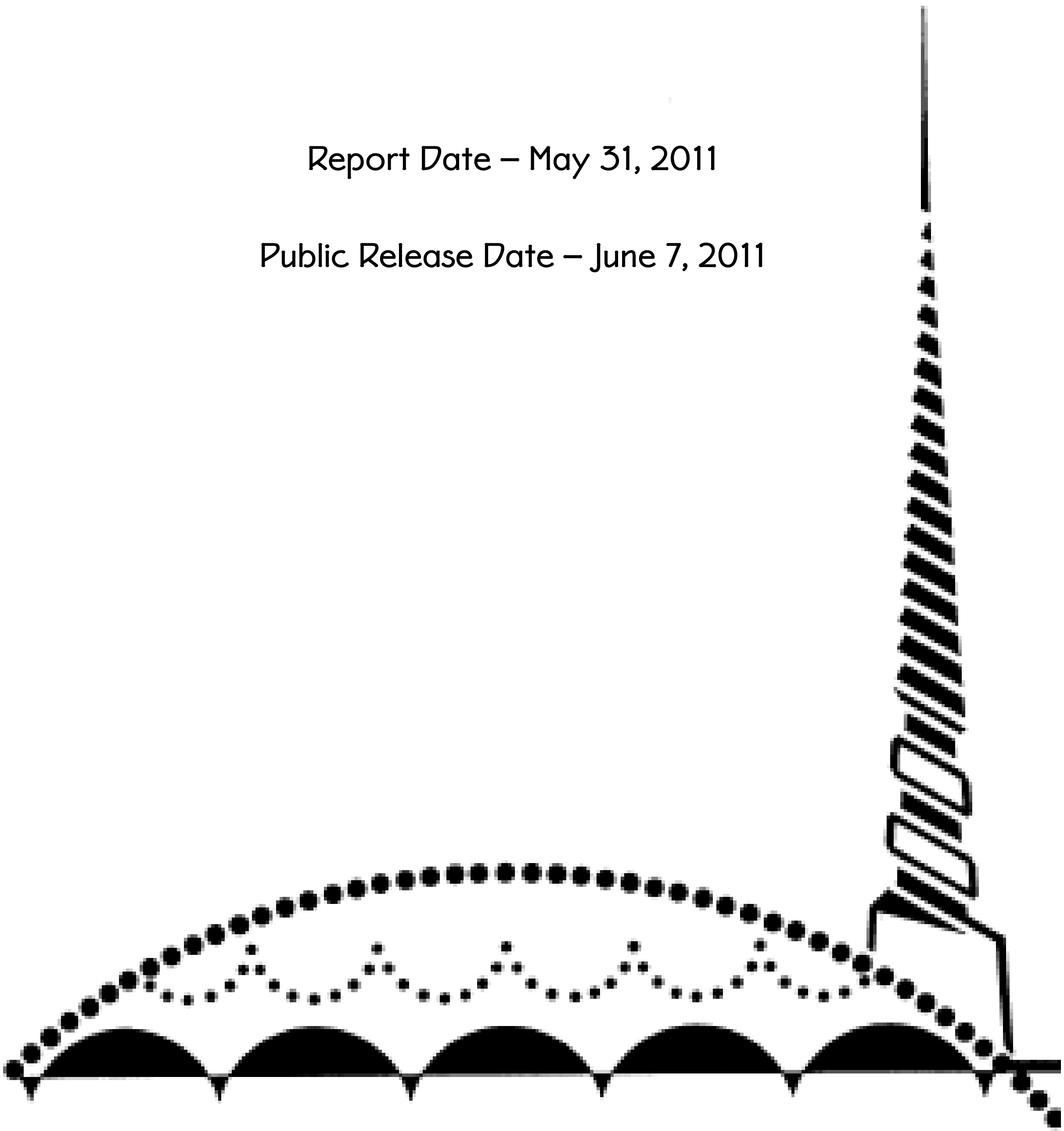
2010-2011 MARIN COUNTY CIVIL GRAND JURY

Public Sector Pensions: A Perspective



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Public Sector Pensions: A Perspective

SUMMARY

During the financial fiasco of 2008 and 2009, the Marin County Employees' Retirement Association's (MCERA) net assets held in trust for pension benefits declined by $386,542,100, a 25.5% drop, due to investment losses. Employer pension costs have increased dramatically, with, for example, San Rafael now paying 50% of payroll, or nearly 20% of General Fund revenue, just to fund its annual pension obligation. Rapid increases in pension costs are disruptive and result in government lay-offs and reductions in services.

The increased cost to employers of pension plans, as a percentage of payroll, coupled with a concurrent loss of income, has caused the County of Marin and the City of San Rafael to take aggressive action to balance their budgets. Although it is tempting to suggest that the cause of the budget problem is high total employee compensation, that is not the acute problem. Employer negotiations with labor determine employee total compensation amount and pension plan provisions. However, the acute problem is unpredictable, rapid variation in compensation – caused at this time by increasing pension costs. Such pension plan cost volatility can be caused, for example, by improving plan benefits with retroactive crediting of prior service and by investment market fluctuations.

MCERA is an independent agency and not under the control of the County. It provides administrative and investment functions for pension plans that are designed to accumulate sufficient funds during an employee's working career to pay the employee's pension during retirement. Both employers and employees contribute to the cost of pensions. MCERA invests the contributions. Typically, investment earnings fund about 60% of the ultimate pension payout with only the remaining 40% being directly funded by employer and employee contributions.

MCERA decisions can dramatically affect investment earnings rates and their volatility. Prior to 1966, California public sector pension funds were generally invested in relatively stable assets such as bonds. California voters then approved Propositions that permitted increased investment risk-taking.

Additionally, MCERA can decide to make payments to retirees that are permitted by retirement law but not specifically included in their retirement plans. Due to actual inflation exceeding plan limitations on cost of living adjustments, some MCERA retirees have lost purchasing power. Prior to 2009, the MCERA Board made supplemental purchasing power protection payments on an ad hoc basis to those retirees. In 2010, the Board enacted policies to provide guidance for future action. Supplemental payments reduce plan assets. When plans are underfunded, employers must make increased payments into the pension plans – ultimately at expense of the taxpayers.

Despite the financial consequences of MCERA decisions, the public has shown little interest in its operations. MCERA should encourage public involvement by increasing visibility into its operations. Making information more readily accessible on its website and increasing the public-friendliness of its meetings would encourage public participation.

This report focuses primarily on three issues:

- the effect of volatility in investment returns on pension plan costs and government budgets, and measures that would reduce that effect,
- supplemental payments (those not specifically provided in the terms of the employee's retirement plan), and
- public visibility into MCERA.

BACKGROUND

At its board meeting on October 13, 2010, the Marin County Employees' Retirement Association (MCERA) approved[1] two new policies: the Interest Crediting policy and the Unrestricted Earnings policy. That approval was over the written objections of both the Marin County Administrator and the San Rafael City Manager, and over the strong oral objections of the Marin County Administrator made at the October 13 meeting.

The MCERA Board action, and its reporting in the local press, drew the attention of the Grand Jury. The Grand Jury decided to improve its understanding of MCERA and to look into the pension issue. We quickly learned that substantial MCERA investment losses in 2008 and 2009 resulted in significantly increased underfunding of MCERA pension plans, and that resultant rising pension costs were creating budget problems for Sponsors.[2]

METHODOLOGY

The Grand Jury interviewed County and San Rafael officials, academics, MCERA board members, staff and consultants, and other interested parties. We reviewed MCERA and County documents, Marin Independent Journal and other press articles, the California Constitution and State law, County Board of Supervisors resolutions, and various reports on pensions. We attended MCERA Board and Committee meetings.

Our investigation provided insight into many controversial aspects of public employee pension plans. While our investigation was underway, the Little Hoover Commission published *Public Pensions for Retirement Security*.[3] That report recommends changes to reduce future pension liabilities for current public workers, to introduce hybrid (both defined benefit and defined contribution) plans, to realign pension benefits and expectations to ensure pension plans are sustainable, and to provide improved public transparency and accountability. Anyone interested in public pensions should read that report.

In April 2010, The Stanford Research Institute for Economic Policy published *Going for Broke: Reforming California's Public Employee Pension Systems*, and in November 2010, it

[1] Minutes, Regular Board Meeting, October 13, 2010, pg 5.

[2] Sponsors, Employer Groups, and Employers all refer in slightly different ways to employers and groupings of employers whose employees' retirement assets are administered by MCERA.

[3] Little Hoover Commission, Public Pensions for Retirement Security, February 2011, available at http://www.lhc.ca.gov/studies/204/report204.html

published *The Funding Status of Independent Public Employee Pension Systems in California.*[4] These reports recommend use of a zero-risk interest rate to compute the present value of pension obligations, which would result in a substantial increase in pension plan liabilities. The Marin County Council of Mayors & Councilmembers created an ad hoc committee on Pension and Other Postemployment Benefits Reform to study and report on the effect on Marin cities and special districts of pensions, retiree healthcare plans, and other postemployment benefits.

These reports have provided and will provide many helpful recommendations. The Grand Jury contemplated expanding this report to include the entire subject of pension reform and aspects of MCERA governance. However, we concluded, especially given the extensive efforts of others, that such an expansion would be a bridge too far.

DISCUSSION

MCERA was formed July 1, 1950, by the Marin County Board of Supervisors' adoption of the County Employees' Retirement Law of 1937[5] (the CERL or the '37 Act, California Government Code Section 31450 et seq.) pursuant to a vote of the people of Marin County. On July 1, 1977, the City of San Rafael, the San Rafael Redevelopment Agency, and the Novato Fire Protection District also became participants in the program.[6] MCERA is a cost sharing, multiple-employer, defined benefit plan, public employee retirement system. It covers employees of more than one employer and pools administrative and investment functions as a common investment and administrative agent for each employer.

MCERA is governed by its Board of Retirement as required by California Government Code Section 31520.1. It is an independent governmental entity separate and distinct from the County of Marin. The Board of Retirement has nine members. Two are elected by County miscellaneous members, one by County safety members, and one by County retirees. Four are appointed by the County Board of Supervisors. The County Director of Finance is an ex-officio member. The elected and appointed members serve three-year terms. MCERA management is responsible for maintaining appropriate controls and preparing financial statements.

Although MCERA is not under the control of the County Board of Supervisors or of its other Sponsors, the Board of Supervisors must adopt provisions of the '37 Act before they become applicable to the retirement plans administered by MCERA. The MCERA Plan Document contains all Board of Supervisors actions related to MCERA operations.

MCERA provides pension plan administration for three main employer groups, the County of Marin, the City of San Rafael, and the Novato Fire Protection District. The County of Marin employer group includes the County, LAFCO, Marin County Courts, Marin/Sonoma Mosquito and Vector Control District, Marin City Community Service District, Southern Marin Fire District, and Tamalpais Community Service District. The City of San Rafael includes the City and the San Rafael Redevelopment Agency.

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[4] Both reports are available at http://siepr.stanford.edu/pubsarchiveorg/1/br

[5] See MCERA's website under Laws & Regulations for a copy of the '37 Act

[6] See the MCERA Financial Statements with Independent Auditor's Report for the Fiscal Years Ended June 30, 2010 and 2009 for additional details.

The MCERA Board of Retirement oversees and guides the Plan subject to the following basic fiduciary responsibilities:[7]

- Solely in the interest of, and for the exclusive purpose of, providing benefits to participants and their beneficiaries, minimizing contributions thereto, and defraying reasonable expenses of administering the Plan.
- Invest and manage Fund assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the Fund. In satisfying this standard of care, the trustees shall exercise reasonable care, skill, and caution.
- Diversify the investments of the Plan to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so. Diversification is applicable to the deployment of the assets as a whole.

In 1992, California voters added additional guidance to the first bullet above when they approved Proposition 162, "The Pension Protection Act", which contained "A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty."

Pension Plan Basics

MCERA's pension plans are designed to accumulate sufficient funds during an employee's working career to pay the employee's pension during retirement. Actuaries compute the required contribution using the Entry Age Normal method.[8] The computation produces a Normal Cost – the amount that must be contributed each year, from the member's plan entry date until the end of his or her projected working life – in order to be able to fund each member's pension benefits. The required contribution amount depends upon the actuarial assumptions for investment rate of return, inflation rate, and other items. Both employers and employees contribute to the cost of pensions.

MCERA invests the contributions. Typically, investment earnings fund about 60% of the ultimate pension payout with the remaining 40% being directly funded by employer and employee contributions.[9] If investments fail to produce the expected rate of return, or if employers change pension plans to pay greater benefits than originally intended, then the pension plans will be underfunded. MCERA Employer Groups are currently only funded to the following levels: County, 72.6%; Novato Fire, 77.1%; and San Rafael, 62.9%.[10] The employers are required to make additional contributions to their pension plans (Unfunded Amortization in Table 1) to correct the underfunding.

[7] MCERA Investment Policy Statement, February 2009

[8] MCERA Actuarial Review and Analysis as of June 30, 2010, Section 1.2

[9] Little Hoover Commission Report, *Public Pensions for Retirement Security*, Feb 2011, pg 10

[10] MCERA Actuarial Review and Analysis as of June 30, 2010, Table 3.3

Table 1
Current Average Pension Plan Contribution Rates
Percent of Payroll

Employer Group	Employer Normal Cost (a)	Unfunded Amortization (b)	Total Employer Contribution[11] (c = a + b)	Employee Contribution[12] (d)	Total Pension Cost (e = c + d)
Marin County	7.82 %	16.01 %	23.83 %[13]	9.66 %	33.49 %
San Rafael	12.82 %	37.18 %	50.00 %	10.92%	60.92 %
Novato Fire	19.21 %	24.45 %	43.66 %	13.36 %	57.02 %

MCERA computes the amount of a new retiree's pension from pension plan rules and employment history. The 2004-2005 Marin County Civil Grand Jury[14] explained the public sector defined benefit pension plan payout formula as follows:

> "In the public sector, employers usually provide pensions using a standard type of formula expressed as a percent of pay (i.e., the benefit factor) for each year of service, multiplied by the employee's final average pay, payable at a stipulated retirement age. For example, commencing at age 55, under a common public sector plan, a retiree might be provided with 2% of his final average pay for each year of service. Under such a plan a retiree with 30 years of service could retire at 55 with a benefit of 60% of final pay."

Of course, there are additional details, not the least of which is the adjustment made if the employee retires before or after the retirement age stipulated in the plan. MCERA provides extensive information on the details of its plans on its website.[15] Although primarily intended to inform employees and retirees, the information is also useful to other interested parties.

Pension Plan Cost and its Volatility

<u>Total Compensation</u>

In considering the effect of public pensions on government budgets, it is tempting to suggest that the issue is actually the total cost of public sector employee compensation and that such compensation is greater than in the private sector. A very experienced politician and former CalPERS Board Member explained the situation thusly "The deal used to be that civil servants were paid less than private sector workers in exchange for an understanding that they had job security for life. But we politicians, pushed by our friends in labor, gradually expanded pay and benefits to private-sector levels while keeping the job protections and

[11] Ibid, Table 3.6
[12] Ibid, Table 3.5
[13] In addition, in FY2011 the County will pay $6,734,435 to service its Pension Obligation Bonds, of which $845,000 will be principal and the remainder interest.
[14] Marin County Civil Grand Jury, *The Bloated Retirement Plans of Marin County, Its Cities and Towns*, May 9, 2005 http://www.co.marin.ca.us/depts/GJ/main/cvgrjr/2004gj/RetirementReport_Final.pdf
[15] See http://www.co.marin.ca.us/depts/RT/main/publications/pubs_main.cfm

layering on incredibly generous retirement packages that pay ex-workers almost as much as current workers."[16]

A California Department of Personnel Administration survey,[17] updated October 7, 2010, shows State administrative and office employees' salaries leading their private sector equivalents by up to 10% and trade and support services employees' salaries leading their private sector equivalents by 4% to 24%. However, executive and managerial employees' and medical and related employees' salaries lag their private sector equivalents. The survey also says that local public sector (counties, cities and towns, and special districts) employees are even better compensated than State employees in all but one of the 41 benchmark classes surveyed. Others, who have not distinguished between employee classifications, have reported that local public sector employee salaries are roughly equivalent to those of private sector employees.

The Marin County Board of Supervisors, in their response to the Grand Jury's May 9, 2005, report said "Taking into account that most private sector pensions are in addition to Social Security, whereas the County's is in lieu of Social Security, we estimate that the average County pension is approximately 22% higher than the average private pension (using the Grand Jury's example)." If salaries are equivalent, then total County compensation, including pensions, is greater on average than private sector compensation.

However, total compensation costs can be accommodated in government long-term plans. The correct level of total compensation must be adequate to attract and keep the quality personnel needed to competently conduct the government's business. That total cost is not the primary cause of the current, unplanned government budget difficulties. That cause is year-to-year volatility in government income and in the cost of total employee compensation, including, in particular, variation in pension costs. The difficulties are widespread and not limited to Marin County. For example, the San Francisco Controllers' Office reports "Employer contributions to the pension system are projected to be a significant driver of benefit cost growth over the next five years as the City pays into the pension fund to recover from investment losses suffered during the economic downturn. The total employer contribution for the City will grow from $360 million in FY 2010-11 to $721 million in FY 2015-16."[18]

The Effect of Pension Cost Volatility on Budgets

The County states in its financial report[19] "Public pensions are also a significant factor contributing to the projected budget shortfall. Equity market losses through June 30, 2009 in Marin County Employee Retirement Association (MCERA) investment assets have created a 30% increase next year in the employer pension contribution – or approximately an $8 million increase in General Fund costs in FY 2010-11. Even with recent stock market gains, pension contributions are expected to increase in the next several years as asset gains and losses are typically smoothed to control rate volatility."

[16] San Francisco Chronicle, January 3, 2010, as reported in the Little Hoover Commission Report

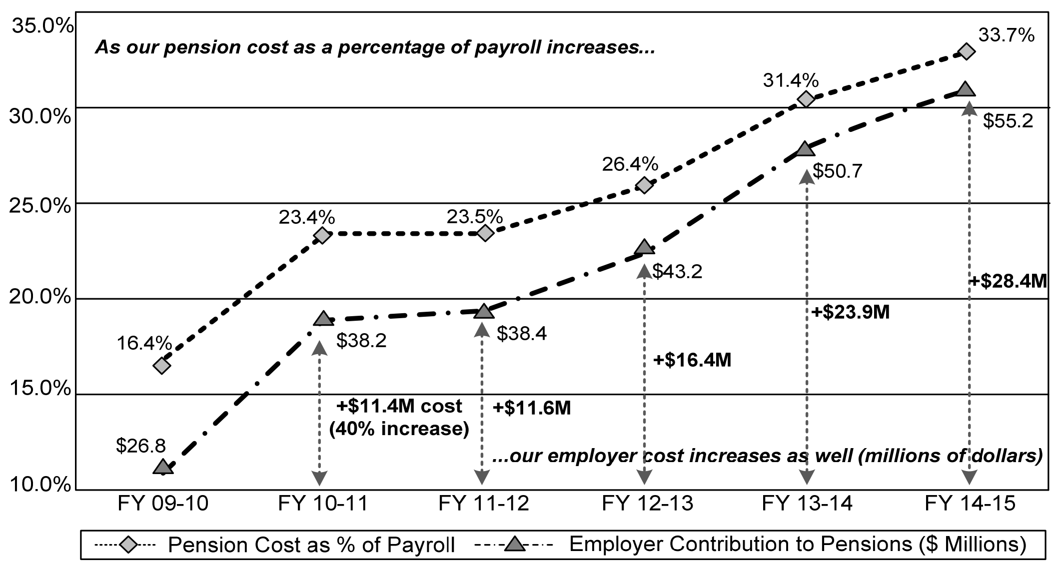
[17] California Department of Personnel Administration, Total Compensation Survey – Salaries, updated October 7, 2010 at 2:26 PM, downloaded April 3, 2011 from http://www.dpa.ca.gov/tcs2006/salaries.htm

[18] County and City of San Francisco, California, Five-Year Financial Plan, Fiscal Years 2011-12 through 2015-16, page 19.

[19] County of Marin Annual Financial Report for the Fiscal Year Ended June 30, 2010, pg 20. http://www.co.marin.ca.us/depts/AC/Main/finance/docs/financial_report/10MarinFinState.pdf

The County also states in its Long-Term Restructuring Plan[20] "At current levels, public pension systems are not financially sustainable without reform. Factors contributing to this conclusion include current economic and investment climates, pension changes in the private sector, longer life expectancies, and an aging workforce. Under current actuarial assumptions, it is projected that the County of Marin will experience an approximately 40% increase in employer pension contribution rates in FY 2010-11, due largely to a 17% decline in the Marin County Employees' Retirement Association (MCERA) investment earnings through June 2009. This represents an increased General Fund cost of approximately $11.4 million next fiscal year, the most significant component of the County's estimated $15 million structural gap for FY 2010-11. Employer costs will continue to rise in subsequent years barring a significant rebound in investment earnings. The chart below illustrates the impact of the MCERA projected increase in County employer rates as a percentage of pay, and the County's increased funding requirements over a five-year period, based upon investment earnings through June 2009:"

Figure 1
County Pension Cost Increases
Current Expectation Based on 2010 Information



Although the impact of pension cost on the County budget is significant, interested citizens will not easily be able to learn that cost by reviewing County financial documents. A portion of the County's cost is related to payment of principal and interest on its 2003 Pension Obligation Bonds, issued to pay down its Unfunded Actuarial Accrued Liability (UAAL) related to the bursting of the stock market Tech Bubble (2000-2002). The Grand Jury has not found a single County document that fully discloses all of its pension costs and their changes over time. That information should be available in a single document.

MCERA and its actuary use techniques to smooth the effects of any variation between the actual investment rate of return and its assumed average. First, the difference is incorporated

[20] County of Marin Long-Term Restructuring Plan: A Blueprint for Financial Sustainability, January 12, 2010

(smoothed) into the calculation of UAAL over five years, with only 20% of the difference being incorporated (smoothed) into the calculation each year. Then the UAAL is amortized over several years.[21] The dramatic results shown above are after such smoothing. To show the smoothing process, the current status of smoothing is shown in Table 2 below. A net market loss of $178,335,390 awaits smoothing into the actuarial value of plan assets and the UAAL, assuring that pension costs will be impacting budgets for years.

Table 2
How Earnings are Smoothed to Compute Actuarial Values[22]

Year	Expected Return	Actual Return	Additional Earnings	Percentage Still to be Smoothed In	Dollars Still to be Smoothed In
2007	104,877,553	232,824,722	127,947,169	20%	25,589,434
2008	123,698,715	(102,239,271)	(225,937,986)	40%	(90,375,195)
2009	112,984,849	(279,024,409)	(196,004,629)[23]	60%	(117,602,778)
2010	87,150,105	92,216,541	5,066,436	80%	4,053,149

<u>Benefit Increases</u>

Granting a pension plan benefit increase without concurrently paying the cost of its retroactive component, as San Rafael did in 2004, can cause self-inflicted variation. When pension increases are granted to employees nearing retirement, the funds needed to pay their additional cost cannot be accumulated through periodic pension plan contributions prior to the employees' retirement. Those costs become a part of the employer's Unfunded Actuarial Accrued Liability (UAAL). They are then amortized (paid by the employer or, with luck, by excess investment earnings) over several years as noted above. Table 3 below shows San Rafael's contribution history.

Table 3
City of San Rafael Employer Pension Plan Cost
Percentage of total payroll[24]

	2002[25]	2003	2007[26]	2010[27]
Normal Cost	12.4	14.19	16.01	12.82
Amortization of UAAL	(1.05)	10.59	25.17	37.18
Total Contribution	11.35	24.78	41.18	50.00
Amount of UAAL	($3,445,000)	$34,212,721	$89,463,204	$146,389,231

The change in San Rafael's Unfunded Actuarial Accrued Liability between 2002 and 2003 resulted from both investment losses and the 2004 benefit increase for Police and

[21] Currently 17 years; however, to improve generational equity, it is anticipated that the amortization period on the non-extraordinary portion of the unfunded liability would stay at 17 years for five years, and then decrease by one year per year until a period of 10 years is achieved. This change will increase year-to-year volatility in employer contribution rate.

[22] MCERA Actuarial Review and Analysis as of June 30, 2010, Section 2.2.

[23] For 2009, 50% of the loss on the market value of assets ($196,004,629) was amortized as a separate base, and this portion of the loss was therefore excluded from the actuarial smoothing procedure.

[24] The UAAL is as of June 30 of the year shown; however, the contribution rates apply to the following fiscal year.

[25] 2002 and 2003 information from MCERA City of San Rafael Annual Actuarial Valuation, June 30, 2003, pg ii

[26] MCERA Actuarial Review and Analysis as of June 30, 2007, Tables 3.7 and 3.10

[27] ibid, Tables 3.6 and 3.10

Miscellaneous members. The unfunded cost of the benefit increase was $18.5 million. That forward transfer of cost to future generations raises a generational equity issue.

Smoothing investment losses of $13.1 million into the UAAL also contributed to the total increase. When San Rafael was granting the benefit increase, MCERA had an additional $171.8 million of investment losses awaiting smoothing in over five years and allocation to Sponsors, including San Rafael, through 2007.[28]

Changes in the Law

Prior to 1966, the State Constitution generally prohibited public pension and retirement funds such as MCERA from investing in stock of companies or corporations. In that year, voter approval of Proposition 1 amended the Constitution to authorize the legislature to enact a law permitting investment of up to 25% of the assets of the fund in common stock and not more than 5% of the assets in preferred stock.[29] In 1984, voter approval of Proposition 21 deleted the constitutional provisions specifying percentage and type of stocks and corporations in which public pension funds may invest. It also empowered the legislature to authorize any investment of a public retirement system's funds, subject to specified standards of fiduciary responsibility.[30]

Those constitutional changes and related legislative action resulted in a shift of pension plan assets from low volatility bonds to higher volatility stocks. Held to maturity, government bonds are a near-risk-free investment. They pay a stable and predictable interest rate. Unfortunately, that interest rate is well below the historic, long-term, total return available from stocks. A lower rate of investment return would require a higher contribution by employers and employees to produce the same pension payments.

Reaching for Yield

The unfunded amortization amounts listed in Table 1 above are an indication of the effect of investment return volatility on annual pension plan cost. In an ideal, predictable world, only the relatively stable Employer Normal Cost and Employee Contribution would be required to fully fund the employee's pension at the time the employee retires. Reality is obviously different. The primary cause of volatility in defined benefit pension plan annual cost is volatility in investment return. As previously mentioned, investment earnings typically provide about 60% of pension fund revenue.

MCERA adopted its Investment Policy Statement in February 2009.[31] That extensive statement sets forth principles for management of their large investment fund. The MCERA policy is not overly conservative; it does not focus investments on fixed income securities and does not require a passive, index-based investment approach.

It is a common truism that asset class investment return is correlated with investment risk. The common proxy for investment risk is volatility. The details depend to some extent on

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[28] MCERA City of San Rafael Actuarial Review And Analysis, June 30, 2003, pg 19

[29] Hastings Law Library, University of California, Hastings College of the Law, Proposition 1, Public Retirement Funds Abbreviated Listing

[30] ibid, Proposition 21, Public Pension Fund Investments

[31] MCERA Investment Policy Statement, February 2009

the time period studied; however, there are general principles. Table 4, columns (a) and (b), presents risk-return information from *Going for Broke: Reforming California's State Pension System*.[32] As can be seen, equities have historically returned 9.26%, well in excess of the 3.7% available from U.S. Treasury Bills. However, in most years the Treasury Bill return can be expected to vary only between 0.7% and 6.7%, whereas the return on equities can be expected to vary between a loss of 11.07% and a gain of 29.59%. Table 4, column (d), shows how the asset classes can be expected to perform as compared to the required rate of return of 7.75% assumed for actuarial calculations. The wide variation in expected probable results demonstrates that employer budgets will continue to be significantly impacted by their pension plans, leading to the conclusion that the plans are not sustainable in their current form. The magnitude of this problem is further discussed below.

Table 4
Risk Return Profiles

Asset Class	Historic Rate of Return (a)	Historic Standard Deviation (b)	Required Rate of Return (c)	Probable Result vs. Required RoR (d = a - c ± b)
U.S. Treasury Bills	3.7%	3.0%	7.75%	-1.05% ; -7.05%
Investment Grade Corporate Bonds	7.25%	4.23%	7.75%	3.73% ; -4.73%
Equities (S&P 500)	9.26%	20.33%	7.75%	21.84% ; -18.82%
Private Equity (Cambridge Index)	12.16%	12.46%	7.75%	16.87% ; -8.05%
Venture Capital (Cambridge Index)	17.83%	29.99%	7.75%	40.07% ; -19.91%

The current MCERA Investment Policy Statement was adopted in February, 2009. In 2007, as the market decline of 2008 and 2009 approached, the MCERA asset allocation was more aggressive than current policy guidance. Table 5 below provides a comparison.

Table 5
MCERA Asset Allocation

	Current Investment Policy	June 30, 2010 Actual	June 30, 2007 Actual
Stock (Equities)	54.0%	60.5%	69.7%
Fixed Income	26.0%	28.4%	18.1%
Real Estate	12.0%	10.4%	12.2%
Private Equity	8.0%[33]	0.7%	0%

MCERA's aggressive 2007 asset allocation left it more exposed to losses from market volatility than it could have been. Compliance with the Investment Policy Statement should limit future exposure to that risk. Table 4 and Table 5 data suggests that MCERA should be able to earn its current assumed Valuation Rate under its current Investment Policy.

[32] Stanford Institute for Economic Research, Going for Broke: Reforming California's State Pension System, May 13, 2010, pg 25
[33] The allocation to Private Equity is relatively new. MCERA expects it will take a few years to identify and fund investment opportunities.

Management of Risk – Making Pension Plans Sustainable

In addition to reducing asset allocation risk, there are many possible ways for MCERA and its Sponsors to reduce pension plan cost volatility. Some are discussed by the Little Hoover Commission, the Stanford Research Institute for Economic Policy, The Marin County Council of Mayors and Councilmembers, and California's Governor. Others are discussed in grand jury reports and in the press. In Marin, the risk is great. The County, for example, has (June 30, 2010) an actuarial accrued pension liability (the amount it is currently committed to pay for all earned pensions) of $1,402,400,000 and an annual total budget on the order of $440,000,000. Even expected small changes in pension plan funding needs can consume a substantial portion of the County's total budget. For example, a 5% loss in a fully funded plan would equal about 16% of the County's total budget. Even given the actuarial techniques used to smooth the loss, that risk is not sustainable.

Eliminating retroactive pension plan benefit increases, such as San Rafael granted in 2004, can eliminate their substantial and sudden impact on pension plan liabilities. As noted previously, pension plans are designed to accumulate sufficient funds during an employee's working career to pay the employee's pension during retirement. When pension benefits are increased, current pension law grants the increase to all employees, including those nearing retirement. It is not possible to accumulate the needed funds during the remaining career of an employee nearing retirement. The result is a transfer of that liability to the employer, and therefore to future generations, by creation of an unfunded pension liability. Under the 12-point pension reform plan put forward by Governor Brown on March 31 of this year, all California public agencies would be prohibited from granting any retroactive pension benefit increases, such as benefit formula improvements that credit prior service. The 12-point plan provides a way to grant pension increases earned from future service without incurring the large, immediate cost a retroactive increase.[34]

Increasing reliance on defined contribution and hybrid plans would reduce employer volatility risk, but transfer it to employees. A defined contribution plan is one to which employers make a defined (specified in labor agreements) periodic contribution during the employee's term of employment to provide a lump sum retirement benefit or an annuity at the time of retirement. A hybrid plan, as the name implies, uses both defined benefit and defined contribution plans to provide a blended (hybrid) source of retirement income.

For example, Marin Energy Authority (MEA) employees participate in a defined contribution benefit plan – perhaps a first for a public agency in Marin County. They also participate in Social Security and have an employee savings plan. They do not have a defined benefit plan. MEA designed its retirement program to provide a "three-legged-stool" assurance for retirement income. That metaphor is intended to convey the idea that private pensions, individual savings and investments, and Social Security are needed to provide stable income security in retirement.[35] MEA will contribute 10% of salary to their employees' pension plan and will pay the employer's share into Social Security. The resultant employer cost is greater than the Normal Cost of Marin County's defined benefit plan for miscellaneous employees;

[34] RN 11 14777, March 29, 2011, An act to amend or repeal sections of the Education and Government Codes

[35] See Social Security website: http://www.ssa.gov/history/stool.html

however, the resultant risk to MEA is reduced by the assurance that payments resulting from future Unfunded Actuarial Accrued Liability will not be required.

Hybrid pension plans include both defined benefit and defined contribution components. Adoption of such plans, either on an employee choice basis or as a required part of a new employee's pension, may provide a reasonable path from the current total reliance on defined benefit plans to a future, sustainable pension system. The risk-return information in Table 4 above suggests that a younger employee, with the time needed to ride out market variation, would benefit from initially building assets by investing in equities, converting to a less risky asset allocation as the employee approaches retirement.

Orange County has adopted a hybrid plan for newly hired workers.[36] It combines contributions by the county and its employees with both a traditional defined-benefit pension and individual defined contribution accounts. The employee can take the individual account with him from job to job. The plan maintains a strong traditional pension, but it reduces the requisite contribution for both the county and its employees. It also redirects a portion of that money into the defined-contribution part of the plan where the money can grow over time.

As an alternative to adopting hybrid plans, adopting a defined benefit plan with shared responsibility for variation in investment returns could be considered. The California Legislative Analyst's Office discussion of that concept[37] suggests that employees should share in decreases and increases in the cost of the pension system, depending on investment performance. That would be accomplished through employee contributions that vary in the same manner as employer rates. The California State Association of Counties believes[38] that "the equitable sharing of pension costs and risks promotes shared responsibility for the financial health of pension systems and reduces the incentive for either employees or employers to advocate changes that result in disproportionate costs to the other party, while diminishing the exclusive impact on employers for costs resulting from increases in unfunded liability." The League of California Cities believes[39] "When employer contribution rates exceed 'normal costs' threshold, employees should be expected to take some of the financial responsibility for those excess increases." Such a sharing would better align the interests of employers and employees and the MCERA Board's fiduciary responsibilities during discussion of plan changes, of supplemental payments, of the assumed average rate of investment return, and of other issues.

Over-funded plans create risk to the pension system because the money in over-funded plans tends to 'burn a hole in people's pockets'. Employers have considered withdrawing excess funds to pay operating costs or to pay down debt. More commonly, employers have suspended contributions to over-funded plans. Employers have agreed with labor to increase pension benefits, sometimes in return for lower salary increases. All of these actions suggest a failure to understand that investment return is expected to vary from the assumed average rate of return used in actuarial calculations. Plans are expected to be over-funded when actual returns have been in excess of the assumed return and to be underfunded when they

[36] Wall Street Journal, Orange County's Public Pension Compromise, January 15, 2011

[37] The 2005-06 Budget: Perspectives and Issues, a Report From the Legislative Analyst's Office to the Joint Legislative Budget Committee

[38] CSAC Guiding Principles for 2005-2006 Pension Reform, reported in California Retirement Dialogue 2010, Comparison Public Pension Principles, Office of Policy and Program Development

[39] League of California Cities: A Framework for Public Pension Reform, 2005-06, reported in California Retirement Dialogue 2010, Comparison Public Pension Principles, Office of Policy and Program Development

have not. If the assumed average rate of return is correct, then the plan will, over time, return to its expected results.

The Employers and MCERA have a variety of options available to them to reduce the risk associated with volatile investment returns. Under the current system, all downside investment risk is transferred to the employers. That has caused and can be expected to continue to cause stress on government budgets and either increases in taxation or loss of services to the public with related reduction in workforce. Working with employees and their representatives, viable options must be selected and implemented to ensure the sustainability of pension plans. The ‘do nothing’ option is not viable. MCERA and its Employers need to agree and document what action will be taken when pension plans appear to be over-funded. Components of that agreement might include:

- Employers either would continue to make Normal Cost contributions or would place an equal amount into a pension stabilization or reserve fund that could only be used to pay down UAAL in future underfunded years.[40]
- Employees would continue to make their contributions.
- MCERA would apply a more conservative asset allocation, reducing risk and stabilizing the plan.

Changes in the law may be required to provide needed risk management solutions to the above concerns and to provide appropriate pension plan options to local governments and pension boards. The ’37 Act limits local choices; however, it has been amended extensively over the years and can be amended again. The County’s Legislative Program,[41] which provides policy direction from the Board of Supervisors on matters of interest, says:

> “Support efforts to implement pension reform in California. Consistent with the 'CSAC[42] Guiding Principles for Pension Reform,' work to amend any legislation to address local concerns. Reforms should include a statewide formula cap on benefits of 2% at 50 for public safety and 2% at 60 for miscellaneous - with any excess to be funded by employee contributions; require that 'final compensation' be calculated using the highest consecutive three-year average salary, and based upon base-salary only; restrict 'safety employee' eligibility to police and fire employees; utilize rate stabilization 'best practices,' such as five-year rate smoothing; reform disability retirement; and protect local control and flexibility. In addition, support efforts to provide under the '37 Act more options for local solutions to consider lower-cost pension alternatives.”

The County should convert the laudable goals of the above statement into action, either through CSAC or otherwise, to effect meaningful change in the ’37 Act.

[40] See Novato Citizens’ Budget Committee, Report on Novato Pension Policy, May 7, 2007, an excellent report, especially considering that it was issued prior to the pension plan losses of 2008 and 2009.

[41] County of Marin, 2011 Federal & State Legislative Programs & Policy Guidelines, Adopted December 7, 2010, pg 5

[42] California State Association of Counties

Cost of Living Adjustments

Many, but not all,[43] public sector pension plans contain automatic cost of living adjustment (COLA) provisions. All plans administered by MCERA contain such provisions and almost all retirees benefit from them.[44] All of the plans also contain a limitation on the maximum annual COLA that can be granted to a retiree, thereby limiting plan benefits and plan costs.[45] The MCERA actuary explains it as follows:[46]

> "A "Standard" cost-of-living-adjustment (COLA) is determined annually based on increase in the Consumer Price Index for All Urban Consumers in the San Francisco-Oakland-San Jose area and is applied on April 1 of each year. However, the Standard COLA cannot exceed a maximum percentage increase in any given year, with the maximum percentage determined based on the CERL Code section applicable to the employment group."

The COLA cost can be a substantial component of the total employer cost (normal cost plus unfunded amortization) of a pension plan. The most recent available data[47] is set forth below.

Table 6
COLA Limits and Contribution

Employer Group	Marin County	San Rafael	Novato Fire
COLA contribution as percent of total employer contribution	20.5%	29.9%	46.3%
Annual COLA Maximum	2%[48]	3%	4%

Supplemental Cost of Living Adjustments

It is possible, over time, for retirees to lose purchasing power due to increases in cost of living in excess of the pension plan contractual caps. The MCERA actuary continues the above explanation:

> "Because the Standard COLA amount granted may be less than the increase in the CPI due to these limitations, the purchasing power provided by the original retirement benefit plus the Standard COLA may decrease over time if the CPI grows faster than the limitations.
>
> Under section 31874.3, the Board of Retirement is authorized to provide a supplemental COLA increase on a one-time only or permanent basis to those members who have lost at least 20% of their original purchasing power."

[43] The Sonoma County plans do not, for example.

[44] When COLA provisions were added to the plans, about a dozen employees objected to paying the incremental cost. Those employees opted out and do not receive either regular or ad hoc COLA adjustments.

[45] MCERA pension plan annual maximum percentage increases (June 30, 2009):
4% - County and Courts Tier 1, Special Districts, and Novato Fire Protection District
3% - City of San Rafael
2% - County and Courts Tier 2 & 3 (most County plan employees)

[46] Graham Schmidt, EFI Actuaries, to Jeff Wickman, MCERA, October 28, 2010, MCERA files

[47] MCERA Actuarial Review and Analysis as of June 30, 2008, Table 3.6.

[48] County employees have differing COLA limits; however, most are now subject to a 2% maximum.

The supplemental COLA would return retirees to 80% purchasing power parity, not to 100%. We will summarize how the process works.

Interest Crediting and Unrestricted Earnings

The MCERA Board's current economic assumptions[49] provide an assumed rate of investment return (sometimes referred to as the interest rate or the Valuation Rate) of 7.75% per year. The Valuation Rate includes a 'real rate of return' of 4.25% per year and inflation of 3.5% per year. Plan Sponsor assets are blended for investment. Semiannually, each Employer Group is credited with interest at the Valuation Rate (approximately 3.8% per half-year). Adjustments are made to account for variance between the Valuation Rate and actual investment performance. The entire process of Interest Crediting is set forth in MCERA policy.[50]

If actual investment returns are adequate to permit crediting each Employer Group's reserves with interest at the Valuation Rate (without the need to create offsetting 'contra accounts' which hold negative balances) with assets left over, then a contingency reserve is filled. If the contingency reserve can be filled to at least 1% of Employer Group assets, then any additional funds can be credited to Undistributed Earnings Reserves and 'excess' or Unrestricted Earnings become available under MCERA policies. It is possible, under applicable accounting and actuarial practice, to fill the reserve accounts even though the plans remain underfunded.

The '37 Act creates the concept of 'excess earnings', defining them to be earnings in excess of the assumed annual average actuarial rate of return on investments. From an actuarial perspective, there is no such thing as excess earnings. The assumed rate of return is an average – the actual rate of return in some years will be higher and in some years lower. The effect of 'excess earnings' is to set a maximum on the return, potentially ensuring that the assumed rate of return, which is an average, will never be achieved. The amount of 'excess earnings' can be adjusted up or down by changing the assumed average actuarial rate of return on investments.

Extracting and paraphrasing from the Kroll Report,[51] the concept of excess earnings rests on a potentially dangerous conceptual error. Excess earnings are not truly 'excess'. If an actuary bases the actuarial calculations on an assumed *average* rate of investment return, then so-called excess earnings (returns exceeding this assumed average in any particular year) are necessary to offset returns in below-average years. In this way, the desired average can be achieved over the long term. For example, if investment returns consistently alternate between years with 9% returns and years with 7% returns, and if the assumed average return is 8%, then there are no truly 'excess' earnings at all, since the 9% years are needed to offset the 7% years.

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[49] The MCERA Policy Regarding Adoption of Economic Assumptions, Amended February 9, 2011, located here: http://www.co.marin.ca.us/depts/RT/main/LAWS_REGULATIONS/Policy%20Regarding%20Adoption%20of%20Actuarial%20Economic%20Assumptions%202011-02-09.pdf

[50] MCERA Interest Crediting Policy, Adopted October 13, 2010, located here: http://www.co.marin.ca.us/depts/RT/main/LAWS_REGULATIONS/Interest%20Crediting%20Policy%202011-02-09.pdf

[51] Report of the Audit Committee of the City of San Diego: Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure, August 8, 2006, Section IV. Violations of Law.

The foregoing notwithstanding, the MCERA Board may consider three possible uses for Unrestricted Earnings, as provided in the Unrestricted Earnings policy. They are:[52]

> **"A.** If at least one percent (1%) of MCERA's total retirement system assets are collectively maintained in the Employee Group Statutory Contingency Reserves and the overall funded status of the plan is 80% or greater, the Board may consider a transfer to a non-valuation reserve or designation to pay an ad hoc supplemental COLA as permitted by law. Ideally, before transferring any assets to such non-valuation reserve, the overall funded status of the plan should be approximately 100%.
> **B.** Transfer to a reserve or designation for other uses as permitted by law.
> **C.** Continue to maintain the funds in the Unrestricted Earnings valuation reserve."

Paragraph A permits payment of a supplemental COLA only when each Employer Group is more than 80% funded (ideally approximately 100% funded). If MCERA investment results meet current actuarial assumptions, 80% funding will only be achieved after 2020.[53] However, the 80%/100% restriction does not appear to apply to paragraph B actions.

Implementation of the Supplemental COLA

The supplemental ad hoc COLAs paid prior to 2009 were paid to retirees who retired in the 1970s and 1980s. In 2010, granting a one-time only supplemental COLA would have provided a supplemental benefit to 58 Marin County retirees in the total amount of $83,528 and to 47 San Rafael retirees in the total amount of $158,935. The estimated present value of providing a permanent supplemental COLA to those retirees was approximately $1.8 million.[54] No Novato Fire retirees would have been eligible to receive a supplemental COLA in 2010. The benefit would have been paid to all retirees who had lost 20% or more of their initial purchasing power – it is not means tested.

The annual amount of the payment was decreasing yearly due to inflation below COLA caps and the passing of recipients. However, our national economy is currently in a delicate condition and there is debate over the expected effect of stimulus spending and high federal deficits on future inflation. If inflation were to return to historic experience,[55] or if the inflation fears of some economists are realized, then recent retirees would soon find themselves with a COLA Bank in excess of 20% and eligible for supplemental ad hoc COLA consideration. Employees who retired in 1990 on a 2% COLA cap plan now have about 15% in their COLA bank. Only an additional 5% would be required. The increased cost to the plan could become significant.

Unless the plan is more than 100% funded, paying an ad hoc supplemental COLA or transferring funds for other uses permitted by law will directly result in increased required employer contributions to the plan. Such action will have an immediate impact on employer budgets. Although MCERA has the sole and exclusive fiduciary responsibility over the

[52] MCERA Unrestricted Earnings Policy Amended February 9, 2011, pg 2, 3

[53] MCERA Actuarial Review and Analysis as of June 30, 2010, pgs 8, 13, and 18.

[54] EFI Actuaries letter to MCERA dated October 28, 2010

[55] The CPI All Urban Consumers, San Francisco-Oakland-San Jose, was 37.7 in 1970, 80.4 in 1980, 132.1 in 1990, and 227.5 in 2010, an average annual increase of 4.6% from 1970-2010, of 3.5% from 1980- 2010, and of 2.8% from 1990-2010.

assets of the public pension or retirement system,[56] it is less than clear that it should have the authority to expend employer and taxpayer funds. However, under the '37 Act the MCERA Board decides whether to make such transfers and not the employers. Marin residents, including those living on limited means, are exposed to risk of reduced government services, increased taxation, and reduced living standards in support of a payment that is neither means tested nor controlled by their elected representatives. In a budget-constrained environment, our elected representatives should decide how limited monetary resources are to be expended.

Public Visibility Into MCERA

MCERA is a major public entity when measured financially. As of June 30, 2010, it managed assets with a market value of $1.21 billion, had an Actuarial Accrued Liability for payment of earned pensions of $1.93 billion, and had an Unfunded Actuarial Accrued Liability of $561 million. MCERA's Board and Committee meetings are subject to the Brown Act and open to the public. Their documents are subject to the Public Records Act. However, it is unusual for a member of the public who does not have a personal interest in an agenda item to attend a meeting. Despite its economic importance and its impact on public budgets with resultant loss of jobs and reduction in services, the public seems to have little interest in what MCERA does or even to know that there is a pension fund manager other than CalPERS. MCERA's Board of Retirement and staff labor, for the most part, in obscurity.

MCERA maintains a good website with information on their activities.[57] That site contains agendas for Board and Committee meetings, excellent minutes of those meetings, various publications (mostly for employees and retirees, but the information is useful to anyone interested in MCERA), a list of their consultants and investment managers, copies of their bylaws and policies, and a copy of the '37 Act. However, the financial information is sparse, consisting only of Condensed Annual Financial Statements (Annual Reports).

In support of the County's mission to encourage meaningful participation in the governance of the County by all[58], and in furtherance of the County's strategy to continue its efforts to redesign and reconfigure its website to modernize its "look and feel" and enable the public to use County's website as a primary source for information, services, and engagement with their County government,[59] the Grand Jury recommends that MCERA make current and historic copies of its important documents directly available to the public on its website:

- Annual Actuarial Review and Analysis reports provide an excellent overview of the status of MCERA's pension plans and extensive detailed support data.
- Complete Financial Statements. The Condensed Annual Financial Statements available on the website provide good information; however, the complete financial statements, which are only available in the Retirement Office for review, should be available on-line.

56 California Constitution, Article 16, Section 17.(a)

57 http://www.mcera.org which points to http://www.co.marin.ca.us/retire/

58 Marin County Mission Statement

59 County of Marin Long Term Restructuring Plan, January 12, 2010, pg 37

- Plan Document, which defines the MCERA pension plan pursuant to Internal Revenue Service requirements.

In addition, MCERA should provide the public with the information needed to understand and validate MCERA's actuarial assumptions, especially its assumed 7.75% (4.25% above inflation) rate of return on investment. This assumption is critical to the actuarial calculation of MCERA's funding needs. If it is higher than actual future performance, Unfunded Actuarial Accrued Liability will increase, as will the need for employer contributions to make up for the underperformance. If it is lower than actual future performance, Normal Cost payments will be excessive. Annual historical asset class investment return and asset distribution could provide useful information to evaluate MCERA's probable future performance and to demonstrate that MCERA's approach to fund management outperforms less costly index investing.

Board meetings break after the first hour for closed session consideration of specific employee items. Meeting attendees are left waiting, often for more than an hour, for the board meeting to reconvene. Increased use of time-certain agenda items would make board meetings more public-friendly.

We have discussed many of the visibility recommendations with senior MCERA management, who indicate they are in the process of improving public access to information.

Conclusion

The County, San Rafael and Novato Fire pension plans are passing through troubled times. The pension plans are managed in accordance with the California's County Employees' Retirement Law of 1937 by the Marin County Employees' Retirement Association, an independent agency which is not under the control of the County Board of Supervisors or of the other plan Sponsors. The pension plans of all MCERA's Sponsors are significantly underfunded, primarily due to investment losses. MCERA currently has reserves with a market value of only $1.21 billion under management. The present value of benefits for members is $1.93 billion.

These are large numbers, especially compared to the annual budgets of the plan Sponsors. Rapid increases in pension costs are disruptive and can result in government lay-offs and reductions in services. Even expected small annual percentage changes in the value of MCERA's assets can have a large impact on Sponsor budgets. Extraordinary losses in value, such as those incurred between late 2007 and early 2009, can have a drastic effect, especially if accompanied by a loss of Sponsor revenue.

At current levels, public pension systems are not financially sustainable without reform. Investment volatility, changes in private sector pensions, and changes in employee demographics contribute to the lack of sustainability. Changes in the pension system that reduce employer risk will improve employer ability to manage budgets and to provide services to the public. However, any such changes must be fair to employees and negotiated with their representatives. This report considers available options that could improve pension plan performance and fairness to all parties.

Limiting maximum annual cost of living increases exposes retirees to the risk of loss of purchasing power. The MCERA Unrestricted Earnings policy provides its Board with the option to make additional payments to retirees from “excess earnings,” the exercise of which will result directly in an increase in required Sponsor contributions. The Sponsors have no control over the Board’s exercise of its options. The concept of “excess earnings” rests on a potentially dangerous conceptual error. Earnings in excess of the assumed average rate of return in some years are needed to offset returns below the assumed average in other years.

MCERA is an important public agency which should provide improved public access to its documents and to the information needed to understand and validate its actuarial assumptions. It should work to improve the public-friendliness of its meetings.

FINDINGS

The Grand Jury finds that:

F1: Changes to the ’37 Act may be required to implement meaningful pension reform.

F2: The County’s Federal & State Legislative Programs & Policy Guidelines document includes support for pension reform in California.

F3: The primary contribution of employee compensation to current budget difficulty is not the amount the employee is paid, it is the volatility of the cost of benefits.

F4: Defined benefit pension plans transfer the cost of all unfunded liability resulting from plan benefit increases and from investment volatility to employer budgets. Sharing that risk through use of defined contribution plans, hybrid plans, shared responsibility for contribution increases or decreases, or otherwise would help employers to manage their budgets, to provide consistent services to citizens, and to provide stable employment for their workforce.

F5: Granting pension increases with a retroactive component to employees near retirement is very costly. It causes sudden increases in unfunded liabilities and in employer cost and raises generational equity issues.

F6: The total cost to Sponsors of pensions, including the cost of Pension Obligation Bonds, and the annual change in that cost, is not easily discovered in public documents.

F7: The lack of a policy to guide action when pension plans are over-funded can result in decisions that cause future underfunding.

F9: MCERA now has an Investment Policy Statement to guide its effort to maximize yield while limiting volatility. As the market decline of 2008 and 2009 approached, MCERA had about 70% of its funds invested in equities, well in excess of its new Investment Policy Statement guidelines.

F10: MCERA documents readily available to the public, including the historic investment performance information provided in its annual Actuarial Reviews, do not include an in-depth comparison of its investment performance to appropriate investment industry standards. The data is not adequate to demonstrate that the current Valuation Rate is consistent with MCERA historic performance.

F11: Limiting maximum annual cost of living increases exposes retirees to loss of purchasing power. The MCERA Unrestricted Earnings policy provides its Board with the option to make additional payments to retirees from “excess earnings”, the exercise of which will result directly in an increase in required Sponsor contributions. The Sponsors have no control over the Board’s exercise of its options.

F12: MCERA has a substantial influence on Sponsor budgets, but the public pays little attention to its operation.

F13: Improving public availability of information could result in increased public attentiveness.

RECOMMENDATIONS

The Grand Jury recommends that:

R1: The County expand the pension provision in its Federal & State Legislative Programs & Policy Guidelines (Legislative Program) to include support for an appropriate sharing between government and labor of the risk of pension plan cost variation.

R2: The County expand its Legislative Program to specifically support generational equity by prohibiting any retroactive pension benefit increases that create an unfunded pension liability.

R3: The County re-affirm its commitment to the pension reform provision in its Legislative Program and work to convert its laudable goals into action, either by working through the California State Association of Counties or otherwise, to effect meaningful change in the ’37 Act.

R4: MCERA improve documentation of investment performance, thereby providing clear information to the public and the MCERA Board on any variation between the performance of MCERA investments and (i) actuarial assumed of rate of return and inflation, and (ii) index-based expectations for an equivalent asset mix.

R5: MCERA use a Valuation Rate consistent with its documented, demonstrated historical performance as adjusted for current asset allocation.

R6: MCERA develop a proposal for consideration by its Sponsors and implementation to reduce the risk inherent in over-funded pension plans.

R7: Plan Sponsors, not MCERA, should have the responsibility and authority to award any payments to retirees that are in excess of retiree contractual entitlements. Support legislative changes needed to move responsibility to plan Sponsors.

R8: MCERA should encourage public involvement by increasing visibility into its operations.

REQUEST FOR RESPONSES

Pursuant to Penal Code Section 933.05, the Grand Jury requests responses from the following governing bodies:

- Marin County Board of Supervisors: **R1, R2, R3**, and **R7**
- Marin County Employees Retirement Association Board of Retirement: **All Findings** and **R4** through **R8**
- San Rafael City Council: **R7**

Governing bodies indicated above should be aware that the comment or response of the governing body must be conducted in accordance with Penal Code Section 933 (c) and subject to the notice, agenda and open meeting requirements of the Ralph M. Brown Act.

California Penal Code Section 933 (c) states that "…the governing body of the public agency shall comment to the presiding judge on the findings and recommendations pertaining to matters under the control of the governing body." Further, the Ralph M. Brown Act requires that any action of a public entity governing board occur only at a noticed and agendized public meeting.

Reports issued by the Civil Grand Jury do not identify individuals interviewed. Penal Code Section 929 requires that reports of the Grand Jury not contain the name of any person, or facts leading to the identity of any person who provides information to the Civil Grand Jury. The California State Legislature has stated that it intends the provisions of Penal Code Section 929 prohibiting disclosure of witness identities to encourage full candor in testimony in Civil Grand Jury investigations by protecting the privacy and confidentiality of those who participate in any Civil Grand Jury investigation.

GLOSSARY

As used in this report, the following terms have the meaning set forth.

'37 Act: County Employees' Retirement Law of 1937, California Government Code Section 31450 et seq.

Active Employee or Active Member: A member of a pension system who is accruing benefits through current employment.

Actuarial Assumptions: Assumptions made about certain events that will affect pension costs. Assumptions generally can be broken down into two categories: demographic and economic. Demographic assumptions include such things as mortality, disability and retirement rates. Economic assumptions include investment return, salary growth and inflation.

Actuarial Valuation: The determination of the normal cost, actuarial accrued liability, actuarial value of assets and actuarial present values for a pension plan. These valuations are performed annually or when an employer is contemplating a benefit change. The valuations compare the assets to the accrued liability for each plan, and determine the employer contribution rate for the coming year. Actuaries use each employer's schedule of benefits, membership data and a set of actuarial assumptions (for example, life expectancy, inflation rates, etc.) to estimate the cost of benefits.

Actuarial Value of Assets: The actuarial value of assets used for funding purposes is obtained through an asset smoothing technique where investment gains and losses are partially incorporated in the year they are incurred, with the remainder smoothed in over subsequent years. This method helps to dampen large fluctuations in the employer contribution rate.

Actuarial Accrued Liability (AAL): The AAL is the total amount (reduced to present value using an assumed rate of return) that is owed under existing agreements to retirees and to current employees based on service rendered to date) who can be expected to retire with a vested pension. It is the amount of money that needs to be invested today so that the principal together with the income it is expected to earn is sufficient to pay these obligations as they come due. Calculating the AAL requires numerous judgments. Using the best available information as of a given date, a reasonable estimate can be made.

Actuarial Present Value of Benefits: The actuarial present value of benefits is the Actuarial Accrued Liability plus actuarial present value of future Normal Costs. The actuarial present value of benefits is also the actuarial present value of all future benefits expected to be paid to the Plan's current members, whether accrued on the valuation data or after.

Actuarial Funding Policy: The plan's actuarial funding policy is the scheduled program of accumulating assets to fund the plan's obligations, typically, but not necessarily, as a level percentage of payroll. The funding policy includes: The Normal Cost, and Amortization of the Unfunded or Overfunded Actuarial Accrued Liability (whichever is applicable).

Assumed Rate of Return: An estimate of the annual rate of investment return to be generated by the fund. This amount is approved by the governing body of the retirement system and has a significant impact on the actuary's estimate of the cost of funding a defined benefit pension plan.

CERL: County Employees' Retirement Law of 1937, California Government Code Section 31450 et seq.

COLA: See Cost of Living Adjustment.

COLA Bank: An account in which that portion of any annual increase in Consumer Price Index which is in excess of retirement plan annual COLA adjustment limitations is accumulated and from which incremental annual COLA adjustments can be made in years when the increase in Consumer Price Index is less than the retirement plan annual COLA adjustment limitations.

Contra account: An account on the balance sheet that offsets the balance of a related and corresponding account.

Cost of Living Adjustment: 100% of Consumer Price Index change up to 2/3/4% annually with banking of any excess. MCERA assumed annual rates of increase are 1.9%, 2.7% and 3.2%, respectively.

Defined-Benefit Plan: A plan designed to provide eligible participants with a specified lifetime benefit at retirement. The benefit is based upon three factors: a percentage rate based on the member's age at retirement and benefit formula applicable to the member, the member's length of credited service and the member's final compensation. The plans are funded by member contributions, employer contributions and income earned from investment of accumulated contributions.

Defined-Contribution Plan: A type of savings plan that allows participants to make pre-tax contributions that accumulate tax-free. Contributions, plus any earnings, are not subject to state or federal taxes until withdrawn, in most cases after retirement. The amount paid is determined by the amount of contributions made and the rate of return on the investments chosen.

Employer: The entity that employs or employed a Member (or employed the individual that earned the benefits now being received by a beneficiary).

Employer Contribution: The amount contributed to the pension plan by the employer, which is the sum of the Employer's Normal Cost and the amortization of the Unfunded Actuarial Accrued Liability.

Employer Group: A group of employers that are treated together for certain purposes. Marin County, San Rafael, and Novato Fire.

Employee: An Active Employee

Employee Contribution: The amount contributed to the pension plan by the employee.

Entry Age Normal method: Under this method, the employer contribution rate provides for current cost (normal cost) plus a level percentage of payroll to amortize the unfunded actuarial accrued liability (UAAL). As of June 30, 2011, the amortization period is 17 years for all groups, with the exception that 50% of the market investment loss for FY2009 is being amortized over a 30 year closed period as a level percentage of pay.

Excess earnings: A concept created by the '37 Act, which defines them to be earnings in excess of the assumed annual average actuarial rate of return on investments. From an actuarial perspective, there is no such thing as excess earnings.

Funded Ratio or Status: A ratio of the value of benefits members have earned compared to the value of the retirement system's assets. The funded ratio or status provides a measure of how well funded or "on track" a plan is with respect to assets vs. accrued liabilities. The funded ratio can be calculated by dividing the actuarial value of assets by the accrued liabilities, or by dividing the market vale of assets by the accrued liabilities.

Inactive Member: A member not currently working for a covered employer, but has member contributions on account.

Interest Crediting policy: An MCERA policy adopted on October 13, 2010. This policy establishes MCERA's methodology to (i) credit interest (investment earnings) to certain MCERA reserves in compliance with the '37 Act, (ii) track and attempt to correct any "deficiencies in interest earnings in other years" that MCERA may experience, and (iii) establish a non-valuation contingency reserve.

MCERA: Marin County Employees' Retirement Association

Member: An employee who qualifies for membership in a pension system and whose employer has become obligated to pay contributions into the pension fund. Also describes retirees, survivors, beneficiaries or anyone receiving a benefit. An Active, Inactive or Retired Member.

Miscellaneous Member or Employee: Any of the vast majority of occupations not designated as a "safety member."

Normal Cost: The annual cost of service accrual for the upcoming fiscal year for active employees. The annual Normal Cost is calculated as the amount necessary to fund each Member's benefits from that Member's Plan entry date to the end of his or her projected working life. The employer normal represents the cost of the additional benefits earned each year by active members.

Normal Retirement Age: The age established in a plan's provisions when members become eligible for full benefits.

Present value: The value today of the value of a future asset or liability, computed using periodic interest rate and the number of periods. For a single future value (FV), interest rate (i), and number of periods (n), the present value (PV) is computed as $PV=FV/(1+i)^n$.

Present Value of Benefits: The total dollars needed as of the valuation date to fund all benefits earned in the past or expected to be earned in the future for current members.

Real rate of return: The actual rate of return less the rate of inflation.

Retired Member: A member currently receiving a benefit. Also known as an annuitant, which can be a retiree, beneficiary or survivor who is receiving a benefit.

Safety Member: A safety member is defined by statute or by plan provisions, and generally refers to an employee working in a job related to preserving the public's safety, such as a firefighter or law enforcement officer.

Smoothing: A technique used to partially incorporate investment gains and losses in the year they are incurred, with the remainder smoothed in over subsequent years. This method helps to dampen large fluctuations in the employer contribution rate. The actuarial value of assets used for funding purposes is calculated through asset smoothing.

Sponsor: Employers and Employer Groups that participate in MCERA pension plans.

UAAL: See Unfunded Actuarial Accrued Liability

Unfunded Actuarial Accrued Liability (UAAL): The amount by which the actuarial accrued liability exceed the actuarial value of assets; or, in other words, the present value of benefits earned to date that are not covered by the value of assets. A plan with an actuarial value of assets below the accrued liability is said to have an unfunded liability and must increase contributions to get back on schedule.

Undistributed Earnings Reserves: An account in which MCERA plan assets may be placed prior to distribution to Employer Group accounts or other disposition.

Unrestricted Earnings (policy): An MCERA policy adopted on October 13, 2010, and most recently amended on February 9, 2011. This policy provides guidance to MCERA on when it is appropriate to declare the existence of "excess" earnings which can be used to pay an ad hoc supplemental COLA or for other uses permitted by law.

Valuation Rate: The Board of Retirement selected interest rate used in valuation calculations (currently 7.75%).