UNFUNDED PENSION LIABILITIES:
EARLY RESULTS UNDER GASB STANDARD 68

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ISSUE

In 2012, the Government Accounting Standards Board (GASB) established a new accounting standard, GASB Standard 68, for public service employee pension plans, effective for Fiscal Year 2014-2015 forward. This standard provides comprehensive accounting frameworks for both defined contribution plans and defined benefit plans. An additional accounting standard, GASB Standard 75, establishes a substantially similar accounting framework for other post-employment benefits (OPEB), mainly for retired employees' health care. Standard 75 will be effective for Fiscal Year 2017-2018 forward.

What have been the early results for reported unfunded pension liabilities for the County of San Mateo (County) and the 20 cities within the County's borders for the first two years under Standard 68?

SUMMARY

The GASB established an improved framework for public sector pension plan accounting under the new GASB Standard 68, effective for Fiscal Year 2014-2015 forward. An additional standard, GASB Standard 75, will provide a substantially similar framework for OPEBs, effective for Fiscal Year 2017-2018 forward. Both standards provide for reporting of net liabilities or assets on the face of government entity balance sheets for the first time and permit reporting of net liabilities or assets as measured at the *prior* year-ends.

The San Mateo County Civil Grand Jury (Grand Jury) has compiled the first two years' reported net pension liabilities (NPLs) for the County and the 20 cities incorporated within the County, per Appendix A. No entity reported net pension assets for either year. Also included in Appendix A are reported OPEB liabilities and assets and other relevant information for Fiscal Year 2015-2016.

Progress in funding status is difficult to assess because of the slight differences between Standard 68 and the prior applicable Standard 27, the short length of time since Standard 68 has been in effect, and the length of time between the measurement dates of assets and liabilities of pension plans and the availability of Comprehensive Annual Financial Reports (CAFRs) reporting them.

There are sources of comfort. By virtue of the County's plan for contributions in excess of statutory requirements, its funding percentage reported for June 30, 2016 exceeds 87%,[1] and full funding appears to be a realistic objective by 2024. Three quarters of the cities within the County report funding percentages above 75%. California's 2013 enactment of the Public Employees'

[1] *County Of San Mateo, California, Comprehensive Annual Financial Report, Fiscal Year Ending June 30, 2016, San Mateo Controller's Office,* 2017, Page iii. http://controller.smcgov.org/sites/controller.smcgov.org/files/documents/files/2016CAFR.pdf, accessed May 20, 2017.

Pension Reform Act (PEPRA) will mitigate the growth rate of liabilities to some extent in the near term and to greater extents over the longer term.

However, most entities' funding percentages decreased and unfunded liabilities increased in Fiscal Year 2015-2016 from the prior year. The plan administrators, the San Mateo County's Employees' Retirement Association (SamCERA) and the California Public Employees Retirement System (CalPERS), both experienced low investment returns in those years. As the County and incorporated cities report NPLs one year later than SamCERA and CalPERS, low returns will be reflected in their Fiscal Year 2016-2017 NPLs. Planned decreases in SamCERA and CalPERS long-term assumed ROIs also will have unfavorable impacts on calculated NPLs in future years.

GLOSSARY

CAFR	Comprehensive Annual Financial Report
CalPERS	California Public Employees' Retirement System
CalSTRS	California State Teachers' Retirement System
County	County of San Mateo
FED	Federal Reserve Board
GASB	Government Accounting Standards Board
NPL	Net Pension Liability
OPEB	Other Post Employment Benefits
PEPRA	Public Employees' Pension Reform Act
ROI	Return on investment
SamCERA	San Mateo County Employees' Retirement Association
UAAL	Unfunded Actuarial Accrued Liability

BACKGROUND

Four previous Bay Area county Grand Jury reports -- San Mateo (2013),[2] Santa Clara (2012),[3] Marin (2015),[4] and Contra Costa (2016)[5] -- have reported funding risks arising in defined benefit pension plans and OPEBs.

In 2014, the Federal Reserve Board (FED) estimated a total unfunded pension liability for Federal employees of $1.8 trillion, funding only 46% of plans' total obligations.[6] That year, the

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[2] San Mateo County Civil Grand Jury, *SamCERA's Unfunded Liability: The Elephant In The Room*, 2013. https://www.sanmateocourt.org/documents/grand_jury/2012/samcera_liability.pdf, accessed May 25, 2017.

[3] Santa Clara County Civil Grand Jury, *An Analysis Of Pension And Other Post Employment Benefits,* May 17, 2012. http://scscourt.org/court_divisions/civil/cgj/2012/pension.pdf, accessed May 25, 2017.

[4] Marin County Civil Grand Jury, *Pension Enhancements: A Case Of Government Code Violations And A Lack Of Transparency*, April 16, 2015, http://www.marincounty.org/~/media/files/departments/gj/reports-responses/2014/pensionsreport.pdf?la=en, accessed May 25, 201

[5] Contra Costa County Civil Grand Jury, *Pension Reform, If Not Now, When?*, May 10, 2016, http://www.cc-courts.org/civil/docs/grandjury/1603_PensionReport_Final_signed.pdf, accessed May 25, 2017.

[6] FEDS Notes, *Introducing Actuarial Liabilities and Funding Status of Defined–Benefit Pensions in the U.S. Financial Accounts*, Federal Reserve, October 31, 2014, https://www.federalreserve.gov/econresdata/notes/feds- notes/2014/introducing-actuarial-liabilities-funding-status-defined-benefit-pensions-us-financial-accounts-20141031.html, accessed May 25, 2017.

FED also estimated total state and local government unfunded pension liability at $1.3 trillion, funding only 75% of plans' total obligations.[7]

The Public Policy Institute of California reported that CalPERS and the California State Teachers' Retirement System (CalSTRS) carried unfunded pension liabilities of $74 billion and $62 billion, respectively, for Fiscal Year 2013/14. Together, these two retirement systems provide future benefits to 2.6 million public sector employees.[8]

Effective as of Fiscal Year 2014-15, GASB Standard 68 implements an improved framework for the accounting of assets, liabilities, and expenses in public sector pension plans, and, in turn, for evaluating financial risk in defined benefit pension plans. In addition, public sector employers generally provide OPEBs, which will be accounted for under a substantially similar GASB Standard 75 from Fiscal Year 2017-2018 forward.

Because changes in accounting methods can make it difficult to compare current and previous years' financial data, the Grand Jury decided to establish a beginning baseline of funding percentages and NPLs under the new Standard for general information purposes, without formal findings or recommendations. Later Grand Juries may add to this baseline over time if they choose to revisit defined benefit pension plan issues in the future.

DISCUSSION

The GASB established an improved framework for public sector pension plan accounting under the new GASB Standard 68, effective for Fiscal Year 2014-2015 forward. An additional standard, GASB Standard 75, will provide a substantially similar framework for OPEBs, effective for Fiscal Year 2017-2018 forward.

SamCERA administers defined benefit pension plans for employees of the County, as well as the San Mateo County Superior Court and the San Mateo County Mosquito Vector and Control District. CalPERS administers defined benefit pension plans for employees of the 20 cities within the borders of the County as well as many other public entities throughout the state. The County and the cities within the County's borders administer their own employees' and retirees' OPEB benefits.

Unlike defined contribution plans, defined benefit plans guarantee determinable payments of benefits to employees after retirement. Standards 68 and 75 require that deficiencies or excesses of assets to pay future obligations related to past service appear on government agencies' balance sheets. For the first two years of Standard 68's effect, the County and all incorporated cities have had such deficiencies, called Net Pension Liabilities (NPLs).

Inherent in the calculation of an NPL is the assumed long-term return on investment (ROI) of assets retained by the plan in advance of payout of benefits. Lower assumed long-term ROI

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[7] Ibid.

[8] Just the Facts, *Public Pension Liabilities in California*, Public Policy Institute of California, 2015, http://www.ppic.org/main/publication_show.asp?i=1157, accessed May 20, 2017.

results in calculations of higher (less favorable) unfunded liabilities.

Some differences between the prior GASB Standard 27 and Standard 68 are:

- The NPL replaces a slightly different measure of underfunding, called the Unfunded Actuarial Accrued Liability (UAAL), still used for calculating statutory annual minimal funding;
- "Smoothing" conventions are slightly different between NPL and UAAL;[9]
- Unlike the UAAL, which was included only in the notes of the financial statements, the NPLs must be included on the face of financial statements, themselves.

In Appendix A,[10] the Grand Jury has compiled an informational baseline for NPLs, as reported in County and incorporated cities' comprehensive annual financial reports (CAFRs) for the first two years of Standard 68's effect. Also included for Fiscal Year 2015-2016 in Appendix A are OPEBs, as reported in notes of the respective CAFRs under existing GASB Standard 45, and other related information.

As mentioned above, accounting improvements may make it difficult to compare current financial data with that of prior periods. Perhaps the most obscure aspect of the application of Standard 68 is the measurement date of NPLs when plan administrators are independent of agency employers. In order to avoid delay in producing agency CAFRs, which depend on CAFRs of plan administrators, agencies may report NPLs as measured at the end of *prior* fiscal years.[11] In other words, the stated NPLs may be between 15 and 20 months in the past by the time agency employer CAFRs are available to the public.

In addition, comprehensive actuarial valuations are not required to be performed annually. They may be performed as much as 18 months prior to the measurement dates or as much as 30 months prior to the fiscal year-ends of the agency CAFRs.[12]

Extracted from CAFRs of the most recent two years, the information contained in Appendix A is among the most important in the CAFRs but is also rather dated by the time the public has the opportunity to see it.

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9 Consistent with accounting conventions used for both private sector and public sector defined benefit pension plans for decades, "smoothing" conventions are used to filter random year-to-year differences between actual and forecasted results when long-term results are reasonably expected to revert to the mean. Smoothing conventions generally accumulate small differences between forecasted and actual results in accrual accounts to be recognized evenly over limited numbers of future years. Differences in excess of small ones are recognized immediately. If such techniques were not used, calculations of unfunded liabilities could fluctuate wildly each year, resulting in undue alarm or overconfidence.

10 Appendix A does not include information for pension plans administered for school districts by the California State Teachers' Retirement System (CalSTRS) or for plans for employees of independent special districts. The Grand Jury sought confirmation of the figures in Appendix A from the County and the 20 cities and received confirmation from 18 of those entities by June 15, 2017; the Grand Jury did not receive confirmations from Half Moon Bay, San Bruno, or Millbrae by that date.

11 See Paragraph 37, *Guide to Implementation of GASB Statement 68 on Accounting and Financial Reporting For Pensions*, Government Accounting Standards Board, 2014, http://www.gasb.org/jsp/GASB/Document_C/GASBDocumentPage?cid=1176163784087&acceptedDisclaimer=true, accessed May 25, 2017.

12 Ibid. See Paragraphs 45 through 51.

As indicated above, unfunded defined benefit pension plan risk has drawn considerable attention. If invested plan assets prove to be insufficient to satisfy retirees' guaranteed benefits, adverse consequences may include:

- Increased taxes and user fees;
- Decreased funds available for local government services;
- Municipal bankruptcy and consequent default on municipal bonds.

Of some comfort, 15 of the 20 cities within the County report funding percentages of 75% or greater in Fiscal Year 2015-2016 CAFRs. The County of San Mateo reports a funding percentage of 87.5% in its Fiscal Year 2015-2016 CAFR,[13] as detailed in Appendix A.

The State Legislature enacted PEPRA in 2013, which imposed mandatory limits on the defined pension benefits for new employees and capped compensation amounts used to calculate defined benefits going forward.[14] PEPRA is expected to mitigate the growth of pension liabilities to some extent in the near future, and the favorable impact will grow over the longer term as employees in PEPRA plans replace those in preceding plans.

However, the County and 18 of the 20 cities within County borders experienced decreased funding percentages for Fiscal Year 2015-2016 compared to those of the prior year. Also, SamCERA experienced low actual investment returns of 3.5%[15] and 0.7%[16] in the two years examined; CalPERS experienced actual ROIs of 2.4%[17] and 0.6%[18] in those years. As County and incorporated cities report NPLs one year later than SamCERA and CalPERS, low returns will be reflected in their Fiscal Year 2016-2017 reported NPLs. Planned decreases in County and CalPERS long-term assumed ROIs will unfavorably impact calculated NPLs in future years.

The baseline compiled in Appendix A may be a useful tool for future Grand Juries if they choose to analyze defined benefit pension plan funding trends over time.

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[13] As indicated in SamCERA Supplemental Contrib Reso.pdf, the County began a plan in FY 2013/2014 to accelerate the payment of unfunded pension liabilities by contributing an additional $50 million that year and an additional $10 million in each of the following ten years, approximately 9% over statutory contributions for those years. Under this plan, the County expects to achieve a 90% funded ratio by mid 2018 and 100% by 2024, if actuarial assumptions used for funding purposes are realized. According to SamCERA's 2015/2016 CAFR, page 14, the County had contributed over $85 million more than statutory contributions to the Plan as of June 30, 2016.

[14] See *PEPRA*, CalPERS, March 7, 2016 for a brief description of the effect of the legislation. https://www.calpers.ca.gov/page/about/laws-regulations/regulatory-actions/pepra, accessed May 25, 2017.

[15] *SamCERA, San Mateo County Employees' Retirement Association, Financial Report, For The Fiscal Year Ended June 30, 2015, A Pension Trust Fund of The County Of San Mateo And Participating Employers, Redwood City, California*, SamCERA,2016, Page 12, http://www.samcera.org/sites/main/files/file-attachments/2015cafr.pdf, accessed May 20, 2017.

[16] *SamCERA, San Mateo County Employees' Retirement Association, Financial Report, For The Fiscal Year Ended June 30, 2016, A Pension Trust Fund of The County Of San Mateo And Participating Employers, Redwood City, California*, SamCERA, 2017, Page 13, http://www.samcera.org/sites/main/files/file-attachments/2016cafr_final.pdf. accessed May 20, 2017.

[17] *2014-15 Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2015,* CalPERS, 2016, Page 3, https://www.calpers.ca.gov/docs/forms-publications/cafr-2015.pdf, accessed May 20, 2017.

[18] *2015-16 Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2016*, CalPERS, 2017, Page 3, https://www.calpers.ca.gov/docs/forms-publications/cafr-2016.pdf, accessed May 20, 2017.

METHODOLOGY

The Grand Jury reviewed public documents discussing the issues of public sector defined benefit pension plan unfunded liabilities throughout the United States and GASB Standards 68 and 75. In addition, it reviewed the CAFRs of SamCERA, the County, CalPERS, and incorporated cities for Fiscal Years 2014-2015 and 2015-2016. The Grand Jury interviewed officials of SamCERA and the County responsible for pension plan administration and financial reporting.

APPENDIX A

SAN MATEO COUNTY AND INCORPORATED CITIES
PENSION AND OTHER POST EMPLOYMENT BENEFITS FUNDING*
Fiscal Years ending June 30, 2016 and 2015
($000)

	2015/2016						2014/2015	
LOCAL AGENCY	**Full- Time**	**$ Covered**	**$**	**%**	**$ OPEB**	**%**	**$**	**%**
	EMPLOYEE	**PAYROLL**	**NPL****	**% FUNDED**	**UAAL*****	**% FUNDED**	**NPL****	**% FUNDED**
SAN MATEO COUNTY	5,439	430,940	466,292	87.5%	150,298	61.0%	389,287	88.9%
Atherton	39	3,249	10,674	80.5%	4,081	46%	9,253	81.9%
Belmont	149	11,764	26,626	76.2%	9,676	37.3%	25,059	76.7%
Brisbane	90	7,101	13,952	79.9%	8,059	6.20%	12,074	82.2%
Burlingame	205	17,183	46,987	77.8%	48,883	16.4%	41,762	80.1%
Colma	45	4,219	7,747	74.7%	13,408	0%	6,885	76.1%
Daly City	444	50,867	112,195	80.0%	58,306	8.2%	99,631	81.9%
East Palo Alto	97	9,257	8,112	78.4%	0	N/A	7,857	70.6%
Foster City	190	17,696	56,390	76.7%	10,714	0.0%	50,458	78.2%
Half Moon Bay	26	N/A	7,319	80.1%	59	88.0%	6,736	81.6%
Hillsborough	83	8,625	17,187	79.4%	13,937	26.2%	14,770	82.2%
Menlo Park	259	19,969	38,881	79.4%	(456)	102.8%	34,371	81.2%
Millbrae	95	6,871	34,256	78.4%	15,613	0%	28,989	79.6%
Pacifica	159	14,405	32,841	82.7%	3,701	0%	28,089	85.0%
Portola Valley	16	1,072	82	98.6%	308	0%	957	83.0%
Redwood City	567	54,275	177,937	70.1%	52,470	25.9%	164,149	71.6%
San Bruno	249	21,413	61,771	75.6%	0	N/A	53,531	78.4%
San Carlos	72	10,486	40,264	67.4%	3,671	25.5%	35,253	71.2%
San Mateo	652	49,788	168,693	70.1%	17,931	8.8%	159,585	71.4%
South San Francisco	551	34,478	130,042	72.2%	57,577	21.9%	124,085	73.2%
Woodside	19	1,671	2,579	75.7%	1,269	24.4%	2,053	79.1%

* Per Comprehensive Annual Financial Reports, Fiscal Years ending June 30, 2016 and 2015

** "Net Pension Liability" per GASB Standard 68, from first effective fiscal year (2014/2015)

*** Other Post Employment Benefits "Unfunded Accrued Actuarial Liability" per GASB Standard 45

HOW APPENDIX A IS COMPILED

Some of the figures in Appendix A are extracted directly from CAFRs. Others are calculated from other figures directly extracted from CAFRs.

Figures for full-time equivalent employees are directly extracted from near the ends of the 2015/2016 CAFRs, if included. If not, they are taken from the 2015/2016 Adopted Budget files. Unlike Covered Payroll, Net Pension Liabilities and their funded percentages, these figures are current as of the reporting year of the CAFRs.

Figures for OPEBs and their funded percentages are directly extracted as "UAALs" as of the dates of their most recent actuarial valuations (usually prior to the reporting year of the CAFRs).

Figures for Covered Payroll, Net Pension Liabilities and their funded percentages are calculated as composites from figures extracted from CAFRs for separate pension plans (If more than one). These figures are current as of the year prior to the reporting year of the CAFRs. CAFRs may report complete data for some plans and abbreviated data for others. An example of the composite calculation is shown below:

	Cov Payroll	Assets	Liabilities	NPL	Funded %
Miscellaneous Plan	50,000	320,000	415,000	95,000	77.1%
Safety Plan	40,000			82,000	75.0%
PEPRA	5,000			6,000	88.0%
Composite	95,000			183,000	

Calculation of the composite funded percentage is accomplished by calculating the missing asset and liability figures: divide the NPLs by 1 minus the funded % to get the liabilities; multiply the liabilities by the funded % to get the assets; add down to get the composite assets and liabilities; and divide the composite assets by the composite liabilities to get the composite funded %.

	Cov Payroll	Assets	Liabilities	NPL	Funded %
Safety Plan		246,000	328,000		
PEPRA		44,000	50,000		
Composite		610,000	793,000		76.9%

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