Item I.A.
Discussion re Creation of Trust for the SB Post-Retirement Welfare Benefits Plan for Executive Staff Employees

Date: April 18, 2007

To: Members of the Investment Subcommittee of the Board Committee on Planning, Program Development and Budget

From: Peggy Van Horn, Chief Financial Officer

Subject: Discussion Regarding Creation of Trust for the State Bar of California Post-Retirement Welfare Benefits Plan for Executive Staff Employees

Executive Summary

The State Bar of California offers post retirement health and vision benefits to executive staff employees who have met certain criteria established in the rules and regulations relating to the employment of executive staff. In order to better manage and control the cost of this retirement benefit, staff proposed the creation of a trust agreement that will account for the funding of the retiree healthcare obligation by utilizing higher yield investment options than those allowed for use in investing general government funds.

During its August 2006 meeting, the Board Committee on Planning, Program Development and Budget approved a resolution recommending that the Board of Governors authorize the Executive Director or her designee to create a trust in a form approved by the Office of General Counsel to hold and invest the funds required to fulfill the retiree healthcare obligation of the State Bar subject to review of the investment subcommittee. The Board of Governors approved the Committee's recommendation.

Background

The State Bar's rules and regulations pertaining to the employment of executive staff employees provide for a health and vision post retirement benefit. In order to receive the benefit, an executive employee must have completed a specified number of years of service and elect to receive retirement distributions from the California Public Employees Retirement System within six months of the employee's termination. At present, the State Bar accrues an annual cost of this benefit based upon current actuarial assumptions, reports the annual expense in the State Bar's General Fund, and invests the monies in accordance with the State of California's requirements for the investing of governmental funds.

In 2006, staff from General Counsel, Finance and Human Resources reviewed several options for the treatment of this benefit that will allow the State Bar to maximize the investment income of the monies set aside for the purpose of funding this benefit and to reduce the State Bar's unfunded liability. Staff consulted with and received actuarial advice that a qualifying trust would best meet the State Bar's goals.

In August 2006, the Board of Governors approved a resolution authorizing the Executive Director, in consultation with the Investment Subcommittee, to create a trust in the form approved by the Office of General Counsel. Attachment 1 is the agenda item presented to the Board of Governors.

This memo will update the investment subcommittee on the status of this project.

Trust Document

Attachment 2 is a draft Declaration of Trust for the State Bar of California Post-Retirement Welfare Benefits Plan for Executive Staff Employees ("trust agreement"). This trust structure is authorized under Section 115 of the Internal Revenue Code. The trust declaration identifies the State Bar as the "trustee" and the Chief Financial Officer as the "Administrator". The roles and responsibilities of these positions are outlined in the trust agreement.

Two major benefits accrue to the State Bar from establishing this benefit program as a trust. The first benefit regards the impact to the State Bar's financial statements. For fiscal years beginning after July 1, 2007, all public entities will be required to record the entire unfunded liability of benefit plans in the financial statements of the organization. Presently, government agencies are permitted to record expenses on a pay-as-you-go basis. As of the end of 2006, the State Bar's actuarially determined liability for future benefits is $17.6 million of which $7.3 million is currently funded. In 2008, the State Bar will be required to record the remaining $10.2 million as an unfunded liability in its financial statements. The establishment of a trust structure will remove the liability from the State Bar's balance sheet and require only a footnote disclosure of the trust's benefit liability.

The second major benefit associated with a trust structure relates to the type of investments the plan will be able to utilize to earn higher rates of return. Under the present structure, the State Bar's investment options are limited to those allowed under California law for the Bar's general governmental funds. The current interest rates earned on the Bar's governmental funds are in the 4% range. By contrast, over the past thirty years, equity indexes have averaged an annual return of approximately 11%. A rise in investment income from the current average return for fixed income investments of 4% to a higher return of 7% is expected to reduce the Bar's expenditures by $12 million over a 30-year period.

Benefits Plan Document

Before the trust can be executed, the State Bar must prepare a plan document to govern the administration of the benefit program. Attachment 3 is a draft of a benefit plan document that sets out the terms and conditions of the benefit program and provides for funding of such benefits under the trust. The final plan document will require Board approval and is tentatively scheduled for the Board's consideration at its July board meeting.

Investment Policy and Options

In conjunction with the trust proposal, staff developed a basic investment policy to authorize the temporary investment of the benefit funds (Attachment 4). The Board's resolution authorized the use of the investment policy upon consultation with the Investment Subcommittee. In its current form, the policy does not include specifics on investment strategies.

Before the end of 2007, staff intends to issue a request for proposal for investment services from organizations that specialize in managing investment portfolios. Upon selection of an investment firm, staff will work with investment professionals to tailor a policy to guide future investments. Because the selection process will require an extensive evaluation period, staff anticipates that a final contract will not be completed before the end of the year.

In the interim period between the date of adoption of the trust and the final selection of an investment advisor, Sam Quan, retired Director of Finance for the State Bar and member of the Investment Subcommittee, has developed a short-term strategy that recommends the use of selected funds from the family of Fidelity mutual funds. Fidelity Investments is one of the world's largest providers of financial services, with custodied assets of more than $2.6 trillion. Attachment 5 is a listing of the recommended Fidelity funds along with historical rates of return for each.

Next Steps

Staff recommends that the Investment Subcommittee meet again during the July Board meeting for final consideration and approval of the Trust and Plan documents. Upon the Investment Subcommittee's concurrence with staff's recommendations regarding the trust structure and investment strategies, and upon the Board's approval of the benefit plan in July, the Executive Director will be able to execute the trust agreement with an anticipated effective date of August 1, 2007. Until an investment advisor is in place, staff may invest the trust proceeds in selected Fidelity Mutual funds.