SCERS
SACRAMENTO COUNTY
EMPLOYEES' RETIREMENT SYSTEM

ITEM 14

For Agenda of:
September 21, 2016

September 16, 2016

TO: President and Members
Board of Retirement

FROM: Richard Stensrud
Chief Executive Officer

SUBJECT: Use of Contingency Reserve in June 30, 2016 Actuarial Valuation

Recommendation:

That your Board determine whether or not to apply any funding from the Contingency Reserve in preparing the actuarial valuation as of June 30, 2016.

Background:

As you know, SCERS has historically sought to maintain a Contingency Reserve as a source of funding to mitigate future investment return shortfalls, unexpected expenses or other factors leading to material cost increases. The Contingency Reserve is 'outside' of the various reserves used by the actuary in the annual actuarial valuation to determine SCERS' funded status and the next year's contribution rates. Funds are placed in the Contingency Reserve in years when the investment returns, after smoothing, are greater than the level necessary to meet the interest crediting rate that represents SCERS' growth target. When the funds in the Contingency Reserve are needed, they are 'transferred' back into the actuarial reserves and are included in the actuarial calculations.

The funding level of the Contingency Reserve has fluctuated over time based on the investment return environment and the need to draw upon it. The Contingency Reserve probably reached its peak level at the end of the 1990's, after an extended period of strong market performance combined with high funded status of the plan. This high level of funding proved to be very beneficial as the Contingency Reserve was an important source of funding to address the additional liability and other expenses incurred as a result of the Ventura court decisions. By utilizing funding from the Contingency Reserve, SCERS was able to substantially mitigate the increase in employer cost that would have resulted from the court decisions. The Contingency Reserve was also a source of funding to help mitigate the cost impact of the investment market downturn in the early 2000's related to the 'Dot Com Bubble.'

The investment markets recovered strongly in the years immediately following and the Contingency Reserve was replenished. Again, this proved valuable when the Global Financial Crisis (GFC) hit in 2008-2009. The balance in the Contingency Reserve had grown to $203.9 million and this funding was applied in the actuarial valuation as of June 30, 2009 to help offset the substantial funding drawdown and subsequent employer cost increase caused by the GFC.

With the rebound in the investment markets following the GFC, funding again became available to restock the Contingency Reserve. By the time of the actuarial valuation as of June 30, 2011, the balance in the Contingency Reserve had grown to $77 million. Because losses from the GFC were still being 'smoothed' into the actuarial calculation and an employer cost increase would result in the next fiscal year, consideration was given at that time to drawing upon the Contingency Reserve to help mitigate the increase. However, because the cost increase was relatively small compared to the employer cost increase expected from the actuarial valuation as of June 30, 2012 (primarily due to a decrease in the investment return assumption), the decision was made to defer drawing upon the Contingency Reserve until the June 30, 2012 valuation. At that time, the $77 million in the Contingency Reserve was moved to the actuarial reserves reducing the employer contribution rate by 0.56% of pay.

The cycle of investment growth and retraction has continued. As a result of several strong years of investment performance post-GFC, the smoothing process moved to a net positive status (i.e., the deferred gains being smoothed in exceeded the deferred losses), and it was possible to replenish the Contingency Reserve. As of June 30, 2015, the balance in the Contingency Reserve had grown to $81.1 million. Over the past few years, however, the investment market performance has been poor with the result that the smoothing process is now in a net negative status (i.e., the deferred losses being smoothed in exceed the deferred gains). That means that unless and until there is investment experience that exceeds the investment return assumption, the deferred investment experience being smoothed in will put upward pressure on employer cost.

The question(s) become, therefore, whether funding should be drawn from the Contingency Reserve to help mitigate the expected cost increases, and if so, when, and in what amount?

This Memorandum will provide your Board with information to consider in answering these questions.

Discussion:

Managing cost increases is the principal reason SCERS has the Contingency Reserve, and as reflected by the discussion above, it has been used effectively for this purpose in the past.

As noted above, the net negative status of the smoothing process will result in upward pressure on employer cost over the next few years. Unless it is offset by investment performance above the investment return assumption, the upward pressure on cost will increase over this period because the deferred gains from earlier periods will be fully smoothed in and only deferred losses will be left to smooth.

It appears that after smoothing, as of June 30, 2015, SCERS will be approximately $60 million short of meeting the target interest crediting rate of 7.50%. That shortfall projects to an increase in the employer contribution rate of approximately 0.48% of pay. If your Board were to apply $60 million from the Contingency Reserve, the cost impact of the negative investment experience would be zero. The balance in the Contingency Reserve would be reduced to $21.1 million. If your Board were to apply all $81.1 million from the Contingency Reserve, the employer contribution rate would decrease by 0.65% of pay, more than fully offsetting the impact of the negative investment performance, but leaving the balance in the Contingency Reserve at zero. In that case, there would be nothing in the Contingency Reserve to help mitigate the increasing upward pressure on cost over the next few years.

The discussion above only considers the projected cost impact of the investment performance. There are other factors that are expected to push downward and upward on employer cost over the next few years.

For example, a factor that is expected to push downward on cost is the shift toward more employees paying 50% of the normal cost. Last year, this resulted in a decrease in the employer contribution rate of approximately 0.64% of pay. In the valuation as of June 30, 2016, it is estimated that this shift will reduce the employer contribution rate by approximately 1.00% of pay. However, this downward pressure on employer cost is expected to decrease in future years as virtually all employees will soon be at 50% cost sharing.

If the analysis were to stop here, it could be summarized as follows: If no funds are drawn from the Contingency Reserve for the June 30, 2016 valuation, the employer contribution rate is projected to decrease by approximately 0.52% of pay. In future valuations, it is expected that the employer contribution rate will increase. SCERS would have $81.1 million in the Contingency Reserve to mitigate that cost increase. If funds are drawn from the Contingency Reserve for the June 30, 2016 valuation, the employer cost reduction will be greater but there will be less funding in the Contingency Reserve to mitigate the expected future cost increases.

However, there are other factors that are likely to push upward on employer cost over the next few years that should be taken into consideration.

As you know, every three years SCERS conducts an experience study to assess whether any actuarial assumptions should be changed. SCERS' next experience study will be conducted in early 2017. Any assumption changes made as a result of the study will be implemented in the June 30, 2017 actuarial valuation, and reflected in the contribution rates that go into effect in the 2018-2019 fiscal year.

SCERS' actuary, Segal Consulting, has indicated that in the upcoming experience study, it anticipates that consideration will need to be given to lowering the investment return assumption. Segal estimates that a 0.25% reduction in the investment return assumption will increase the employer contribution rate by approximately 2% of pay. Segal has further indicated that it expects consideration will also need to be given to changing the mortality assumption which will result in additional upward pressure on the employer contribution rate.

The cost impact of such assumption changes, combined with the expected increase in employer cost from the other factors noted above, suggest that greater cost increases are expected in the June 30, 20107 valuation and those following than the experience expected in the June 30, 2016 valuation.

Overall, the factors for your Board to consider in deciding whether, when and how to utilize the Contingency Reserve are similar in many respects to the factors faced by your Board in 2011 and 2012. At that time, your Board decided that the best course of action was to defer utilizing funds in the Contingency Reserve now in order to deploy them to offset more substantial expected cost increases in the near future. That was a reasonable and prudent decision then, and would be the same today.

I hope this information is helpful. I will be happy to answer any questions you might have.

Respectfully,

Richard Stensrud
Chief Executive Officer