SACRAMENTO COUNTY
EMPLOYEES' RETIREMENT SYSTEM

ITEM 15

For Agenda of:
December 21, 2016

December 16, 2016

TO: President and Members
Board of Retirement

FROM: Richard Stensrud
Chief Executive Officer

SUBJECT: Member Contribution Account Interest Crediting Rate
Effective December 31, 2016

Recommendation:

Authorize Staff to credit interest to the member contribution reserves based on the provisions of the Interest Crediting and Unallocated Earnings Policy ('Policy'), that is, at a rate equal to one-half of the 5-Year Treasury Note rate in effect on December 31, 2016 or one-half of the interest crediting rate for the other valuation reserves, whichever is lower.

Background:

The Interest Crediting and Unallocated Earnings Policy ('Policy') calls for a different (lower) interest crediting rate for the member contribution reserves than the interest crediting rate used for the other actuarial valuation reserves. The rationale for the differential crediting rate is based on recognition that: (a) The ultimate retirement benefit a member receives is primarily funded by the other valuation reserves and not the member contribution reserves; and (b) Unlike the other valuation reserves, the member contributions can be withdrawn from the system. Accordingly, under the Policy it is a higher priority to try to meet the funding targets for the other valuation reserves than to grant a fixed level of interest to the member contribution reserves, particularly in periods where there are insufficient funds available to meet all the funding targets.

Currently, the semi-annual target crediting rate under the Policy for the other valuation reserves is 3.75% (7.50% annually). In contrast, the semi-annual target crediting rate for the member contribution reserves is one-half of the 5-Year Treasury Note rate as in effect on the last business day of the interest crediting period, provided however, that: (a) Regardless of the applicable Treasury Note rate, the member contribution reserve crediting rate cannot exceed 3.75%; and (b) If the projected interest crediting rate for the other valuation reserves is less than 3.75%, the interest crediting rate for the member contribution reserves will be one-half of the projected interest rate of the other valuation reserves or one-half of the Treasury Note rate, whichever is lower.

Attached is a Memorandum from Chief Operations Officer Kathryn Regalia outlining the analysis utilized in developing the proposed interest crediting rate for the member contribution reserves, effective December 31, 2016. As you will see, Staff has determined that SCERS will not be able to meet the overall target crediting rate of 3.75% for all valuation reserves for the period, with the interest crediting rate for the valuation reserves, excluding the member contribution reserves, projected to be 3.51%. As a point of comparison, the 5-Year Treasury Note rate as of December 13, 2016 was 1.92%, meaning that one half of that rate will be approximately 0.96%.

As previously noted, pursuant to the Interest Crediting and Unallocated Earnings Policy, the crediting rate for the member contribution reserves is the lower of one-half of the applicable 5-Year Treasury Note rate as of December 31, 2016 or one-half of the projected interest rate for the other valuation reserves. Based on the information above, if that determination was being made as of the date of this memorandum, the lower crediting rate would be the Treasury-based rate, and this would be the rate used to credit member accounts.

Staff is further recommending that the applicable interest crediting rate be implemented at first opportunity after December 31, 2016.

Discussion:

I concur with the analysis and Staff recommendation.

As noted in the memorandum from Staff, the investment performance in the first six months of the fiscal year (last six months of 2016) has been solid, with the return of approximately 5.1% running ahead of the target six month growth rate of 3.75%. Correspondingly, the actual market gain for the period of approximately $393.6 million exceeds the $297.3 million target gain for fully crediting the valuation reserves. As a result, approximately $96 million in gains will be added to the seven year smoothing process, which reduces the net deferred losses in the smoothing process from $555.5 million to $421.3 million.

However, when the deferred losses from the smoothing process that must be recognized in the current interest crediting period are factored in, the available funding is not sufficient to meet the six month interest crediting target. Specifically, the portion of the above target six month gain that is recognized – approximately $7.4 million (one-half of one seventh of the above target gain) – is offset by $37.9 million in deferred losses phased in via smoothing from previous periods, producing a net shortfall of $30.5 million. As a result, the overall interest crediting rate of 3.27% (for all valuation reserves) falls short of the 3.75% target interest crediting rate.

Notwithstanding the current period shortfall, the overall picture has improved. The investment performance entering the second half of the fiscal year is ahead of pace, enhancing the chances that the performance for the year will exceed the investment return assumption. Similarly, the above target performance in the current period has made a meaningful reduction in the level of deferred losses to be recognized going forward.

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

Respectfully,

Richard Stensrud
Chief Executive Officer

Attachment

SCERS
SACRAMENTO COUNTY
EMPLOYEES' RETIREMENT SYSTEM

December 16, 2016

TO: Richard Stensrud
Chief Executive Officer

FROM: Kathryn T. Regalia
Chief Operations Officer

SUBJECT: Interest Crediting on Employee Reserve (Member Contribution) Accounts for the Six Months Ending December 31, 2016

Recommendation:

I recommend that the Retirement Board authorize staff to credit the Employee Reserve (member contribution accounts) for the six-month period ending December 31, 2016 with interest at a rate equal to one-half of the 5-year Treasury Note rate in effect on December 31, 2016 or half of the interest rate applied to the other valuation reserves, whichever is lower.

Background:

The SCERS Interest Crediting and Unallocated Earnings Policy provides the following guidance pertaining to employee reserves:

> Interest will be credited to the active employee contribution reserves semi-annually. The interest crediting rate will be one-half of the United States 5-Year Treasury Note Rate for the last business day of the interest crediting period in the Federal Reserve Statistical Release H.15 Selected Interest Rates, with the following provisos: (a) the active member contribution reserves interest crediting rate will be no greater than one-half of the actuarial assumed earnings rate (currently 7.5%); and (b) if the projected interest crediting rate for the other valuation reserves is less than one-half of the overall target crediting rate for the valuation reserves (i.e., 3.75% or one-half of 7.5%), the interest crediting rate for the active member contribution reserves will be one-half of the interest rate applied to the other valuation reserves or one-half of the Treasury Note Rate, whichever is lower.

Analysis:

In order to determine whether SCERS has sufficient earnings to credit employee reserves, several factors were considered and analyzed. Following are the findings based on pre-year end estimated financial data:

- Based on the most recent Actuarial Valuation and Review as of June 30, 2016, SCERS had net deferred loss from prior years of $555.5 million, of which $37.9 million is scheduled to be recognized as a loss in the first six months of the 2016-2017 fiscal year.

- SCERS' net market value of assets as of November 30, 2016 was $8,011.5 million, an increase of approximately $330.6 million over the net market value of assets as of June 30, 2016. SCERS' actual gain on the market value of assets for the first five months of the year approximated $393.6 million or 5.1%.

- The target market return for the six-month period was $289.8 million. The target market return is calculated by multiplying the average market value of assets by the target earnings rate of 3.75% (one-half of the annual target rate of 7.5%).

- The $393.6 million actual gain for the period outperformed the target market return of $289.8 million by $103.8 million. As a result, a gain of $393.6 million for the period will be integrated into the smoothing process.

- With seven-year smoothing, half of one-seventh of the gain in excess of the target market return ($103.8 million), or a gain of $7.4 million, will be combined with the net deferred gains and losses from past smoothing periods that are scheduled to be recognized in the first six months of the 2016-2017 fiscal year.

- Applying the gains from the current period through the smoothing process will result in $7.4 million being offset against the deferred losses of $37.9 million from past smoothing periods to leave a net amount of $30.5 million of losses that are scheduled to be recognized in the first six months of the 2016-2017 fiscal year.

- The total amount available for use during the current six-month period is $259.3 million, comprised as follows:

  - $289.8 million (target market return)
  - $(37.9) million (amount of net deferred losses from prior smoothing periods)
  - $7.4 million (amount of smoothed gains in the current period)

- The target market return for the period is based on the average market value of net assets over the six-month period. However, the actual interest crediting obligation as of December 31, 2016, will be based on (1) the valuation reserves and not the market value of net assets; and (2) the adjusted balance of the valuation reserves as of June 30, 2016. Accordingly, the amount required to credit all valuation reserves at an overall rate of 3.75% as of December 31, 2016, is estimated to be $297.3 million. Valuation reserves were estimated based on actual contribution and benefit payment experience through November 30, 2016 and a projection of consistent experience for the month of December 2016.

- The total amount available for interest crediting for the six-month period ended December 31, 2016 of $259.3 million is less than the $297.3 million amount needed to credit all reserves at an overall rate of 3.75%. Accordingly, the estimated overall crediting rate for all valuation reserves is 3.27%.

- The 5-Year Treasury Note rate that will be utilized in determining the interest crediting rate for the employee reserve will be the rate as of December 31, 2016. As of December 13, 2016, the 5-Year Treasury Note rate was 1.92%. If that rate was in effect on December 31st, the rate credited to employee reserves would be 0.96%.

- In order to credit all valuation reserves at an overall rate of 3.27%, the estimated crediting rate for the other valuation reserves (employer, retiree, and death benefit reserves) is 3.51%.

- While the rate could increase between now and December 31st, under the Interest Crediting and Unallocated Earnings Policy, the employee reserve crediting rate would be capped at one half of the amount applied to other valuation reserves (i.e. one half of 3.51% or 1.75%).

- This estimate may change if investment returns in December are substantially lower or the Treasury Note rate changes or the ratio of employee reserves to total valuation reserves varies from staff estimates. However, an increase in the Treasury Note rate will not affect the amount needed to credit all reserves.

Discussion:

In sum, based on SCERS' investment performance to date, the net amounts to be recognized from prior years' net deferred gains, and current period net losses, SCERS will be able to credit the employee reserves at one-half of the 5-year Treasury Note rate to be published for December 31, 2016, and SCERS will have sufficient funds to credit all valuation reserves the overall mid-year 3.27% (6.54% annually) interest crediting rate.

The Board's approval of this request will enable staff to more efficiently serve our members, since the interest crediting process will commence in early January without delay.
This will enable more expedient processing of the following member items:

- Active member annual statements
- Retirement application processing
- Withdrawals
- Public service credit purchases

If you have any questions or concerns, please let me know.

Respectfully submitted,

Kathryn T. Regalia
Chief Operations Officer