Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 15

MEETING DATE: **September 20, 2017**

SUBJECT: **Use of Contingency Reserve in the June 30, 2017 Actuarial Valuation**

SUBMITTED FOR: ___ **Consent** __X__ **Deliberation and Action** ___ **Receive and File**

RECOMMENDATION

Staff recommends that the Board affirm the use of $36.3 million from the Contingency Reserve to fully credit interest at the overall assumed annual earnings rate of 7.5% for fiscal year 2016-17, consistent with the Board's Interest Crediting and Unallocated Earnings Policy.

PURPOSE

To appropriately establish the balances as of June 30, 2017, for all contribution and reserve accounts and communicate those balances in a timely manner to the plan actuary for use in completing the annual actuarial valuation as of that date.

DISCUSSION

The authority of the Board in applying the available earnings to contribution and reserve accounts is governed by the California State Constitution (Article XVI, Section 17), the County Employees' Retirement Law of 1937, and other provisions of state and federal law applicable to public retirement systems.

California Government Code Sections 31592 and 31592.2 establish that crediting interest to contributions and reserves is the highest priority with respect to the use of available earnings, and that earnings in excess of total interest credits shall remain in the fund as a reserve against deficiencies in interest earnings in other years, losses on investments, and other contingencies.

Crediting interest to total valuation assets at the assumed annual earnings rate whenever possible helps to stabilize future plan costs, and avoids increasing the Unfunded Actuarial Accrued Liability (UAAL) due to an interest crediting shortfall.

The Board's Interest Crediting and Unallocated Earnings Policy states that:

> "Interest will be credited in a manner designed to, and with the goal of, keeping the total actuarial valuation assets on track with the actuarial earnings assumption…..Available earnings will be comprised of (a) the actual earnings of the retirement fund based on the smoothed actuarial value of assets; and (b) funds previously set aside in the contingency reserves."

At the Retirement Board meeting held June 21, 2017, the Board approved staff's recommendation for crediting interest to member contribution (employee reserve) accounts for the six-month period ending June 30, 2017, at a rate that is equal to one-half of the 5-year Treasury Note rate in effect on June 30, 2017. The discussion in that agenda item also presented an estimate of funds available for interest crediting overall at 7.067% for the fiscal year ended June 30. 2017. The interest crediting rates presented in June were based on the estimated market value of assets as of May 2017 and contribution and benefit payment experience through May 31, 2017, and a projection of consistent experience for the month of June 2017.

<u>Updated Estimate of Funds Available for Interest Crediting</u>

As staff is performing the fiscal year-end close and preparing SCERS financial statements based on actual data through June 30, 2017, the information for interest crediting for fiscal year 2016-17 has been updated.

SCERS' actual gain on the market value of assets as of June 2017 approximated $1,027.9 million (or 13.4%). This increase in market value exceeds the expected market return of $576.7 million (at 7.5%) by $451.2 million, which will be recognized in valuation assets over the seven-year actuarial asset smoothing period. The investment gain achieved in 2016-17 will reduce the deferred losses from $555.5 million as of June 30, 2016, to $104.3 million as of June 30, 2017.

Of the $451.2 million gain, $64.4 million (one-seventh) will be recognized in valuation assets for the actuarial valuation as of June 30, 2017. When combined with the $75.7 million of net deferred losses to also be recognized this year, the net loss to be recognized as of June 30, 2017 is $11.3 million.

The estimated of funds available for interest crediting overall based on actual earnings and recognition of net deferred losses at June 30, 2017 is $307.3 million. This would result in overall interest crediting for all valuation reserves for fiscal year 2016-17 at 7.165%, which is less than the assumed annual earnings rate of 7.50% (applicable through June 30, 2017).

<u>Application of Contingency Reserves to Achieve the Target Interest Crediting Rate</u>

As of July 1, 2017, the Contingency Reserves balance was $81.1 million. If the Board affirms the use of $36.3 million from the contingency reserve to credit interest at the assumed earnings rate of 7.50% for fiscal year 2016-17, consistent with the Board's Interest Crediting and Unallocated Earnings Policy, the contingency reserve balance as of June 30, 2017 would be $44.8 million. The amount available for interest crediting overall at June 30, 2017, would be $343.7 million. This would result in interest crediting for fiscal year 2016-17 at 7.625% (due to compounding of the interest credit as of December 31, 2016).

BACKGROUND

Government Code section 31592.2 requires that earnings in excess of the total interest credited to contributions and reserves shall remain in the fund as a contingency reserve. Only when the contingency reserve exceeds one percent of system assets may a retirement board transfer all or any part of such surplus in excess of one percent to county advance reserves. The Retirement Board's policy sets a contingency reserve target equal to 3% of plan assets for SCERS.

While the Interest Crediting and Unallocated Earnings Policy is intended to serve as a guideline for the decisions of the Board, under the law the Board retains substantial discretion with respect to such matters. This includes the right to deviate from or alter a stated policy or procedure if the Board determines that such action is reasonable, appropriate and prudent with respect to the Board's exercise of its fiduciary duties to secure the sound funding of the retirement system, and to act in the best interests of the system as a whole.

Since at least 2014, the Board has annually considered alternatives and determined how to apply unallocated earnings and use of contingency reserves in the annual actuarial valuations for the plan. Past recommendations and actions have recognized the policy goal to:

> "Maintain a sound funded status of the retirement system through the reasonable and prudent application of available earnings, including establishing a level of contingency reserves sufficient to make a meaningful contribution toward mitigating future earnings shortfalls and unexpected expenses."

In 2014, for the first time since 2010, SCERS had unallocated earnings of approximately $91.1 million (after application of the multi-year asset smoothing process and crediting interest on valuation assets at the assumed annual earnings rate). The Board applied one half of the unallocated earnings for the June 30, 2014 actuarial valuation to the unfunded liability (due to past interest crediting shortfalls) and one half to the contingency reserve.

In 2015, SCERS had unallocated earnings of approximately $71.2 million. The Board applied one half of the unallocated earnings for the June 30, 2015 actuarial valuation toward deficiencies from past periods and one half to the contingency reserve.

In 2016, SCERS did not have unallocated earnings, and the Board was asked to determine whether or not to apply any amount from the $81.1 million Contingency Reserve in preparing the actuarial valuation as of June 30, 2016. Staff advised that there was a $60 million shortfall in crediting interest on valuation assets at the 7.50% assumed annual earnings rate for fiscal year 2015-16. There was considerable discussion of the upcoming actuarial experience study and likely recommendations for a reduction in the annual earnings rate assumption and changes to the mortality tables for the plan, which would put upward pressure on plan costs and contribution rates. The Board decided not to use funds in the Contingency Reserve for the actuarial valuation as of June 30, 2016.

STEPS FOLLOWING BOARD ACTION

The Board's current policy specifies a number of goals, priorities and principles. In recent years, staff has submitted recommendations for Retirement Board consideration and action for the use of unallocated earnings or contingency reserves to determine contribution and reserve account balances for the annual actuarial valuation.

As part of the overall SCERS policy review project currently underway, staff anticipates recommending revisions to the Interest Crediting and Unallocated Earnings Policy that would provide sufficient guidance to staff in the normal course of business based on actual annual investment results, yet allow for alternative actions by the Board if and as warranted.

ATTACHMENTS

Estimates of Funds Available for Interest Crediting
Interest Crediting and Unallocated Earnings Policy (Adopted September 2006)
Agenda Item 5 from Regular Meeting of June 21, 2017 re Interest Crediting
on Member Contribution Accounts for June 30, 2017
Text of Government Code Sections 31592 and 31592.2

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Estimate of Funds Available for 2016-17 Interest Crediting
(Projected as of May 31, 2017)

	Amount Required to Credit All Valuation Reserves at the Assumed Earnings Rate (7.5% Annually) (In Millions)	**Amount Available for Interest Crediting** (In Millions)	**Estimated Interest Crediting Rates**		
			Employee Reserves	**All Other Reserves**	**Overall for all Reserves**
December 2016 Interest Crediting	$297.3	$258.1	0.965%	3.490%	3.256%
June 2017 Interest Crediting	$304.5	$299.8	0.875%	3.973%	3.691%
FY 2016-2017	**$601.8**	**$557.9**	**1.848%**	**7.602%**	**7.067%**

Amount Available for 2016-17 Interest Crediting Without the Application of Contingency Reserves

(Estimated as of June 30, 2017)

Market Value of Assets
(in Millions)

June 30, 2016	June 30, 2017	Increase
$7,680.9	$8,570.2	$889.3

Return in Excess of Expected Return

	FY 2016-2017 (in Millions)
Average Market Value of Assets	$7,690.0
Expected Return (7.5%)	$576.7
Estimated YTD Return as of June 30, 2017	$1,027.9
Return in Excess of Expected Return	**$451.2**

Change in Net Deferred Loss
(in Millions)

	Amount	FY 2016-2017 Gains/(Losses) Recognized	Deferred Gain/(Loss)
Net Deferred Loss as of June 30, 2016	($555.5)	($75.7)	($479.8)
Return in Excess of Expected Return FY 2016-2017	$451.2	$64.4	$386.7
Net Deferred Loss as of June 30, 2017	**($104.3)**	**($11.3)**	**($93.1)**

Amount Available for Interest Crediting
(in Millions)

Expected Return (7.5%)	$576.7
FY 2016-2017 Loss Recognized	($11.3)
Total Available for Interest Crediting FY 2016-2017	$565.4
Interest Credited in December 2016	($258.1)
Available for Interest Crediting in June 2017	**$307.3**

Estimated Interest Crediting
Without the Application of Contingency Reserves
(Updated Estimate as of June 30, 2017)

	Amount Required to Credit All Valuation Reserves at the Assumed Earnings Rate (7.5% Annually) (In Millions)	Amount Available for Interest Crediting (In Millions)	Overage/ (Shortage)	Estimated Interest Crediting Rate: Employee Reserves	All Other Reserves	Overall for all Reserves
December 2016 Interest Crediting	$297.3	$258.1	$(39.2)	0.965%	3.490%	3.256%
June 2017 Interest Crediting	$304.5	$307.4	$2.9	0.945%	4.071%	3.785%
FY 2016-2017	**$601.8**	**$565.5**	**$(36.3)**	**1.848%**	**7.703%**	**7.165%**

Estimated Interest Crediting
<u>With</u> the Application of Contingency Reserves
(Updated Estimate as of June 30, 2017)

	Amount Required to Credit All Valuation Reserves at the Assumed Earnings Rate (7.5% Annually) (In Millions)	Amount Available for Interest Crediting (In Millions)	Overage/ (Shortage)	Estimated Interest Crediting Rate		
				Employee Reserves	All Other Reserves	Overall for all Reserves
December 2016 Interest Crediting	$297.3	$258.1	$(39.2)	0.965%	3.490%	3.256%
June 2017 Interest Crediting	$304.5	$343.8	$39.2	0.945%	4.563%	4.232%
FY 2016-2017	**$601.8**	**$601.9**	**$0.0**	**1.848%**	**8.212%**	**7.626%**

Contingency Reserves
(Projected as of June 30, 2017)

	Beginning Balance	Contingency Reserve Used for Interest Crediting	Ending Balance
Contingency Reserves	$81.1 million	$(36.3) million	$44.8 million
Amount Available for June 2017 Interest Crediting	$307.4 million	$36.3 million	$343.7 million

SACRAMENTO COUNTY EMPLOYEES' RETIREMENT SYSTEM

Interest Crediting and Unallocated Earnings Policy

Purpose of the Policy:

The policies and procedures outlined in this document represent the goals, priorities and methodologies for applying available earnings to the reserves of the Sacramento County Employees' Retirement System (SCERS), as determined by the SCERS Board of Retirement ('Board'). The authority of the Board in such matters is governed by the provisions of the County Employees' Retirement Law of 1937 ('1937 Act'), Article XVI, Section 17 of the California Constitution, and other provisions of state and federal law applicable to public retirement systems. While the policies and procedures outlined herein are intended to serve as guidelines for the decisions of the Board, under the law the Board retains substantial discretion with respect to such matters. This includes the right to deviate from or alter a stated policy or procedure if the Board determines that such action is reasonable, appropriate and prudent with respect to the Board's exercise of its fiduciary duties to secure the sound funding of the retirement system, and to act in the best interests of the system as a whole.

Fundamental Objective:

Maintain a sound funded status of the retirement system through the reasonable and prudent application of available earnings, including establishing a level of contingency reserves sufficient to make a meaningful contribution toward mitigating future earnings shortfalls and unexpected expenses.

Statement of Goals, Priorities and Principles:

1. Pursuing full funding of the vested retirement benefits and a contingency reserve equal to 3% of plan assets are co-equal, first priority goals.

2. Funding for non-vested benefits, or the application of funds to other purposes permitted by the 1937 Act, will only be considered by the Board if and when the vested retirement benefits are more than 100% funded and contingency reserves equal at least 3% of plan assets. The Board reserves the right to set funding and contingency reserve thresholds greater than the levels noted, or to otherwise decline to consider such alternative application of funds if the Board determines that such actions are reasonable and prudent for securing long-term stability of the costs of the vested benefits of the retirement system.

3. Interest will be credited in a manner designed to, and with the goal of, keeping the total actuarial valuation reserves on track with the actuarial

earnings assumption (currently 7.50% per annum). A lower interest crediting rate will be utilized for the active member contribution reserves (as described in paragraph 6 below), but the difference between that lower rate and the 7.50% target crediting rate for the other actuarial reserves will be applied to the other valuation reserves so that the overall valuation reserve crediting rate is maintained at 7.50%, subject to the provisions regarding available earnings set forth immediately below.

4. Interest will be credited to the actuarial valuation reserves to the extent that there are available earnings. Available earnings will be comprised of (a) the actual earnings of the retirement fund based on the smoothed actuarial value of assets; and (b) funds previously set aside in the contingency reserves. Crediting interest at the overall valuation reserve target crediting rate (currently 7.50%) is the highest priority with respect to the use of available earnings, however, based on the Board's assessment of what is in the overall best interests of the retirement system, the Board reserves the right to determine whether, and to what extent, it will draw upon the contingency reserves to achieve the target crediting rate. If the funds available to credit interest, as determined by the Board, are not sufficient to credit interest at the target crediting rate, the funds available shall be applied on a pro rata basis to the valuation reserves, taking into account the differential crediting rate for the active member contribution reserves.

5. Actual earnings of the retirement fund (based on the smoothed actuarial value of assets) that remain unallocated in a given interest crediting period after, but only after, meeting the full target interest crediting rate for that period (currently 3.75% or one-half of 7.50%), will be applied equally toward (a) addressing earnings deficiencies related to past periods; and (b) establishing target contingency reserve levels. The equal application of such unallocated earnings will continue until such time as the retirement system has achieved a 100% funded status and established contingency reserves equal to 3% of plan assets, respectively. When one goal is reached, the full amount of the unallocated earnings will be applied toward the second goal. When both goals are reached, the Board, in its discretion, and consistent with its fiduciary duties, may consider establishing higher thresholds, or the application of some or all of the funds toward other purposes permitted by the 1937 Act. At any point, however, including prior to reaching stated target funding levels, if the Board determines that it is in the best interest of the retirement system to do so, the Board may utilize unallocated earnings to establish contingency reserves earmarked for an identified, anticipated and extraordinary future expenditure.

6. 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 7.50%); 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 7.50%), 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.

Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 5

MEETING DATE: **June 21, 2017**

SUBJECT: **Interest Crediting Rate on Member Contribution Accounts for June 30, 2017**

SUBMITTED FOR: **_X_ Consent** **___ Deliberation and Action** **___ Receive and File**

RECOMMENDATION

Staff recommends the Board authorize staff to credit interest to member contribution (employee reserve) accounts for the six-month period ending June 30, 2017, at a rate that is equal to one-half of the 5-year Treasury Note rate in effect on June 30, 2017 or equal to one-half of the interest rate applied to the other valuation reserves, whichever is lower.

The Board's approval of this request prior to the effective interest crediting date will enable staff to more efficiently serve our members, since the interest crediting process will commence in early July. This will enable more expedient processing of retirement applications, contribution withdrawals, and public service credit purchases.

PURPOSE

To comply with the requirements of County Employees' Retirement Law of 1937, Article XVI, Section 17 of the California Constitution, and other provisions of state and federal law applicable to public retirement systems requiring SCERS to apply available earnings to the active member contribution reserves.

DISCUSSION

In accordance with the law and the Board's Interest Crediting and Unallocated Earnings Policy, interest is credited to member contribution accounts semi-annually on June 30th and December 31st**. Staff estimates that SCERS will have sufficient funds to credit the member contribution accounts at one-half of the 5-year Treasury Note rate** to be published for June 30, 2017, and to credit all valuation reserves at the overall 3.69% interest crediting rate for the six-month period ending June 30, 2017 or 7.07% annually.

Staff's interest crediting estimate is based on the estimated 2016-2017 fiscal year-end financial data, most significantly impacted by SCERS' investment performance for the fiscal year and the portion of net deferred losses to be recognized in valuation assets for this fiscal year.

Estimate of Funds Available for Interest Crediting

The following findings were applied in estimating the funds available for interest crediting:

	June 30, 2016	*May 31, 2017*	*Increase*
Market Value of Assets (in Millions)	$7,680.9	$8,521.3	$840.5

SCERS' actual gain on the market value of assets as of May 2017 approximated $973.7 million (or 12.7%). This increase in market value exceeds the expected annual increase of $576.9 million by $396.8 million, which will be recognized in valuation assets over the seven-year actuarial smoothing period.

	FY 2016-2017 (in Millions)
Average Market Value of Assets	$7,692.7
Expected Return (7.5%)	$576.9
Estimated YTD Return as of May 31, 2017	$973.7
Return in Excess of Expected Return	$396.8

One-seventh, or $56.7 million, of the $396.8 million gain will be recognized in valuation assets for fiscal year 2016-17. When combined with the $75.7 million of net deferred losses to also be recognized this year, the net loss to be recognized in 2016-17 is $19 million.

	(Amounts stated in Millions)		
	Amount	**FY 2016-2017 Gains/(Losses) Recognized**	**Deferred Gain/(Loss)**
Net Deferred Loss as of June 30, 2016	($555.5)	($75.7)	($479.8)
Return in Excess of Expected Return FY 2016-2017	$396.8	$56.7	$340.1
Net Deferred Loss as of June 30, 2017		**($19.0)**	**($139.7)**

The estimated amount available for interest crediting during the current fiscal year is as follows:

	Amount (in Millions)
Expected Return (7.5%)	$576.9
FY 2016-2017 Loss Recognized	($19.0)
Total Available for Interest Crediting FY 2016-2017	$557.9
Interest Credited in December 2016	($258.1)
Available for Interest Crediting in June 2017	**$299.8**

The assumed annual increase in asset market value is based on the estimated average market value of net assets. However, the actual interest crediting obligation as of June 30, 2017, will be based on (1) the actuarially smoothed value of valuation reserves, rather than the market value of net assets; and (2) the adjusted balance of the valuation reserves as of the June 30, 2017 actuarial valuation.

Estimated Interest Credits

The estimated amount required to credit all valuation reserves at the assumed earnings rate of 7.50% and the estimated amount available for interest crediting for the 2016-17 fiscal year are shown below:

	Amount Required to Credit All Valuation Reserves at the Assumed Earnings Rate (7.5% Annually)	**Amount Available for Interest Crediting**	**Estimated Interest Crediting Rate**		
			Employee Reserves	**All Other Reserves**	**Total**
December 2016 Interest Crediting	$297.3 million	$258.1 million	0.965%	3.490%	3.256%
June 2017 Interest Crediting	$304.6 million	$299.8 million	0.875%	3.973%	3.691%
FY 2016-2017	**$601.9 million**	**$557.9 million**	**1.848%**	**7.602%**	**7.067%**

Valuation reserves were estimated based on actual contribution and benefit payment experience through May 31, 2017 and a projection of consistent experience for the month of June 2017.

Variability of Estimated Interest Crediting for June 30, 2017

The 5-Year Treasury Note rate that will be used in determining the interest crediting rate for member contribution accounts as of June 30, 2017. As of June 8, 2017, the 5-Year Treasury Note rate was 1.75%. If that is the rate on June 30th, member contribution accounts for the six-month period ending June 30th would be credited with 0.875% interest.

While the rate could increase between now and June 30th, 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 3.97% or 1.75%).

This estimate may change if investment returns in June are substantially lower, if the Treasury Note rate changes, or if 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.

BACKGROUND

The Interest Crediting and Unallocated Earnings Policy provides guidance pertaining to member contribution accounts:

> 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 7.50%); 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 7.50%), 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.

ATTACHMENTS - None

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Text of California Government Code Sections 31592 & 31592.2

31592.

Earnings of the retirement fund during any year in excess of the total interest credited to contributions and reserves during such year shall remain in the fund as a reserve against deficiencies in interest earnings in other years, losses on investments and other contingencies, except as provided in Sections 31529.5 and 31592.2.

31592.2.

(a) In any county, earnings of the retirement fund during any year in excess of the total interest credited to contributions and reserves during such year shall remain in the fund as a reserve against deficiencies in interest earnings in other years, losses on investments, and other contingencies, except that, when such surplus exceeds 1 percent of the total assets of the retirement system, the board may transfer all, or any part, of such surplus in excess of 1 percent of the said total assets into county advance reserves for the sole purpose of payment of the cost of the benefits described in this chapter.

(b) Where the board of supervisors has provided for the payment of all, or a portion, of the premiums, dues, or other charges for health benefits, Medicare, or the payment of accrued sick leave at retirement to or for all, or a portion, of officers, employees, and retired employees and their dependents, from the county general fund or other sources, the board of retirement may authorize the payment of all, or a portion, of payments of the benefits described in this subdivision from the county advance reserves. This payment shall comply with the requirements of Section 401 of Title 26 of the United States Code. Payment may be made directly from the county advance reserves for the benefits described in Section 31691.1.