SCERA Retirement Board Meeting

Negative Contingency Reserve
July 20, 2023

SCERA Negative Contingency Reserve

- Negative Contingency Reserve
  - In order to explain the Negative Contingency Reserve we need to understand how investment earnings are calculated and distributed
    - We will discuss actuarial smoothing of investment gains and losses
    - We will discuss interest crediting to reserves
  - We also need to understand how the Plan treats investment earnings that are left over after interest crediting to reserves
    - We will discuss Unapportioned Earnings
  - Then we can discuss why the Negative Contingency Reserve was created
    - Track interest crediting shortfalls
    - Determine availability of Unapportioned Earnings above a certain level to fund Ad Hoc COLA benefit

SCERA Negative Contingency Reserve

- Actuarial Valuation
  - Each year SCERA's actuary performs an actuarial valuation
    - Compares actuarial assumptions to the Plan's experience
    - The Plan assumes it will earn 6.75% by investing Plan assets
    - The actuary takes what we actually earn and applies SCERA's funding policy to recognize (smooth) the earnings over a five-year period
    - SCERA uses the recognized earnings to determine how much is available to credit interest to its reserves – called Available Earnings

SCERA Negative Contingency Reserve

- "Unapportioned" Earnings
  - Every 6 months SCERA credits interest to its statutory reserves from Available Earnings (Government Code Section 31591)
    - Member contributions
    - Employer contributions
    - Annuitants (Benefit recipients)
    - Cost of Living Adjustment (COLA) – COLAs already granted
    - COLA - Future – Future COLAs
  - Any earnings that are left over after interest crediting (Unapportioned Earnings) are **required** by statute to "remain in the fund as a reserve against deficiencies in other years, losses on investments and other contingencies, except as provided in Sections 31529.5 and 31592.2" (Government Code Section 31592)
  - SCERA tracks these Unapportioned Earnings in the Interest Fluctuation Reserve

SCERA Negative Contingency Reserve

- How can Unapportioned Earnings in the Interest Fluctuation Reserve be used
  - Section 31529.5 allows Unapportioned Earnings over 1% of total plan assets to be used to hire legal counsel and is not relevant to this discussion
  - Section 31592.2 allows Unapportioned Earnings over 1% of total plan assets to be transferred to “county advance reserves” for the sole purpose of paying benefits described in the County Employees Retirement Law (CERL) sections of the Government Code
    - County Advance Reserve is also known as Employer Advance Reserve
    - Benefits described in the CERL include Ad Hoc COLA benefits
    - By policy amendment in 2002 SCERA Board increased the 1% to 3%

SCERA Negative Contingency Reserve

- Documenting an Interest Crediting Procedure
  - SCERA amended its COLA policy in November of 2002 to define Unapportioned Earnings and document its interest crediting procedure
    - Described the order in which available investment earnings were apportioned
    - Defined Unapportioned (excess) Earnings
    - Created an "Employer Advance Reserve Contra Tracking Account" which is what we now call the Negative Contingency Reserve
    - Increased the 1% of plan assets contingency to 3%

SCERA Negative Contingency Reserve

Sufficient Available Earnings to Credit Reserves

Available Earnings

- Credit interest to Employer, Member, Annuitant, COLA and COLA - Future Reserves

Remaining Balance

- Restore Negative Contingency Reserve and bring Interest Fluctuation Reserve to 3% of total System assets

Remaining Balance

- Balance over 3% of assets available to fund Ad Hoc COLA

SCERA Negative Contingency Reserve

Insufficient Available Earnings to Credit Reserves

Available Earnings

- Credit Member, Employer, Annuitant, COLA and COLA - Future Reserves

Not enough earnings to fully credit reserves

- Draw down COLA – Future Reserve
- Draw down Interest Fluctuation Reserve

Not enough earnings to fully credit reserves

- Track balance in Negative Contingency Reserve

SCERA Negative Contingency Reserve

- Why was the Negative Contingency Reserve created in 2002
  - COLAs are funded from excess Unapportioned Earnings
    - Policy shift in public defined benefit plan community regarding true "excess" earnings
  - The Plan was experiencing its third straight year of investment losses
  - Concern that available reserve balances were strained and had been significantly depleted
  - Earnings forecasts were low
  - COLA – Future Reserve, which was a reserve funded with Unapportioned Earnings up to this point, was in danger of being entirely depleted
  - Fear of potential shortfalls in future Available Earnings to credit interest

SCERA Negative Contingency Reserve

- 2003 Available Earnings shortfall
  - COLA - Future Reserve used to supplement Available Earnings and credit interest to reserves
- 2004 & 2005 Available Earnings shortfall
  - Zeroed out COLA - Future Reserve to credit interest
  - Used a portion of the Interest Fluctuation Reserve to credit interest so no longer at 3% of Plan assets
- 2006 & 2007 Available Earnings surplus
  - COLA - Future Reserve remains at zero
  - Interest Fluctuation Reserve built back up after interest crediting

SCERA Negative Contingency Reserve

- 2008 – Available Earnings Shortfall
  - COLA – Future Reserve remains at zero
  - Interest Fluctuation Reserve balance ($62 million) used to credit interest to reserves
  - Still a shortfall of $46 million
  - $46 million tracked in Negative Contingency Reserve

SCERA Negative Contingency Reserve

Negative Contingency Reserve Balance

- 2009 -$143 million
- 2010 -$222 million
- 2011 -$361 million
- 2012 -$502 million
- 2013 -$469 million
- 2014 -$459 million
- 2015 -$491 million
- 2016 -$528 million
- 2017 -$521 million
- 2018 -$571 million
- 2019 -$581 million
- 2020 -$583 million
- 2021 -$527 million
- 2022 -$598 million

SCERA Negative Contingency Reserve

UAAL and Negative Contingency Reserve are not the same thing

- Unfunded Actuarial Accrued Liability (UAAL)
  - Tracks changes in assets and liabilities from contributions, investment and demographic gains and losses and assumption changes
  - Reduced by future actuarial gains (including investment gains) and UAAL contributions

- Negative Contingency Reserve
  - Tracks interest crediting shortfalls
  - Occurs when smoothed investment earnings less than assumed earnings on a cumulative basis
  - Reduced when smoothed investment earnings on the total reserve balance are more than assumed earnings

SCERA Negative Contingency Reserve

- Further Discussions
  - August 24th Board meeting
    - Discuss policy options with plan actuary
      - Negative Contingency Reserve
        - Keep
        - Abolish
        - Set to zero – reset and keep
        - Other options
      - Interest Fluctuation Reserve 1%, 3%, different amount
      - Interest Crediting – what to credit or track when there are shortfalls in Available Earnings

SCERA Negative Contingency Reserve Appendix

- **Actuarial Value of Assets** – Market Value of Assets minus deferred investment gains and losses
- **Available Earnings** – the net increase or decrease in Plan assets after accounting for Cash Flows, administrative expenses, and net investment income
- **Cash Flows** – employee and employer contributions paid into the Plan and benefits paid out
- **COLA Reserve – Future** – a reserve funded with Unapportioned Earnings in excess of interest crediting and 3% of the Plan's Market Value of Assets apportioned to the Interest Fluctuation Reserve to fully fund 2 years' worth of prospective Ad Hoc COLAs on an actuarial basis
- **Interest Fluctuation Reserve** – required by Government Code section 31592 to hold 1% of the Plan's Market Value of Assets. Benefits can only be paid when assets exceed this amount. Board policy set this at 3%

SCERA Negative Contingency Reserve Appendix

- **Market Stabilization Reserve** – the difference between the current fair market value of Plan assets and the actuarially smoothed value of assets
- **Market Value of Assets** – An asset value where the full value of investment earnings is recognized in a calendar year
- **Negative Contingency Reserve –** tracks available investment earnings shortfalls due to smoothed investment returns less than the actuarially assumed investment rate of return as well as truing up reserves annually
- **Net Investment Income** – investment earnings on the Actuarial Value of Assets minus administrative expenses
- **Unapportioned Earnings** – earnings remaining after Available Earnings exceed the amount credited to the Valuation Reserves, the Negative Contingency Reserve is zero, and the Interest Fluctuation Reserve is 3% of the Plan's Market Value of Assets