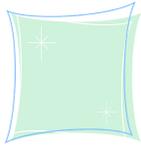




SCERA Retirement Board Meeting

Negative Contingency Reserve

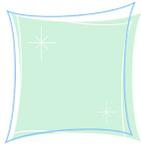
July 20, 2023



SCERA Negative Contingency Reserve

■ Negative Contingency Reserve

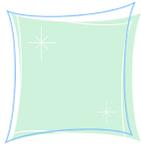
- In order to explain the Negative Contingency Reserve we need to understand how investment earnings are calculated and distributed
 - We will discuss actuarial smoothing of investment gains and losses
 - We will discuss interest crediting to reserves
- We also need to understand how the Plan treats 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

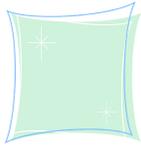
- Each year SCERA's actuary performs an actuarial valuation
 - Compares actuarial assumptions to the Plan's experience
 - The Plan assumes it will earn 6.75% by investing Plan assets
 - The actuary takes what we actually earn and applies SCERA's funding policy to recognize (smooth) the earnings over 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

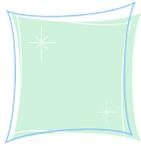
■ “Unapportioned” Earnings

- 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



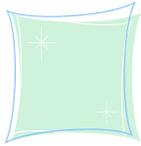
SCERA Negative Contingency Reserve

- 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%

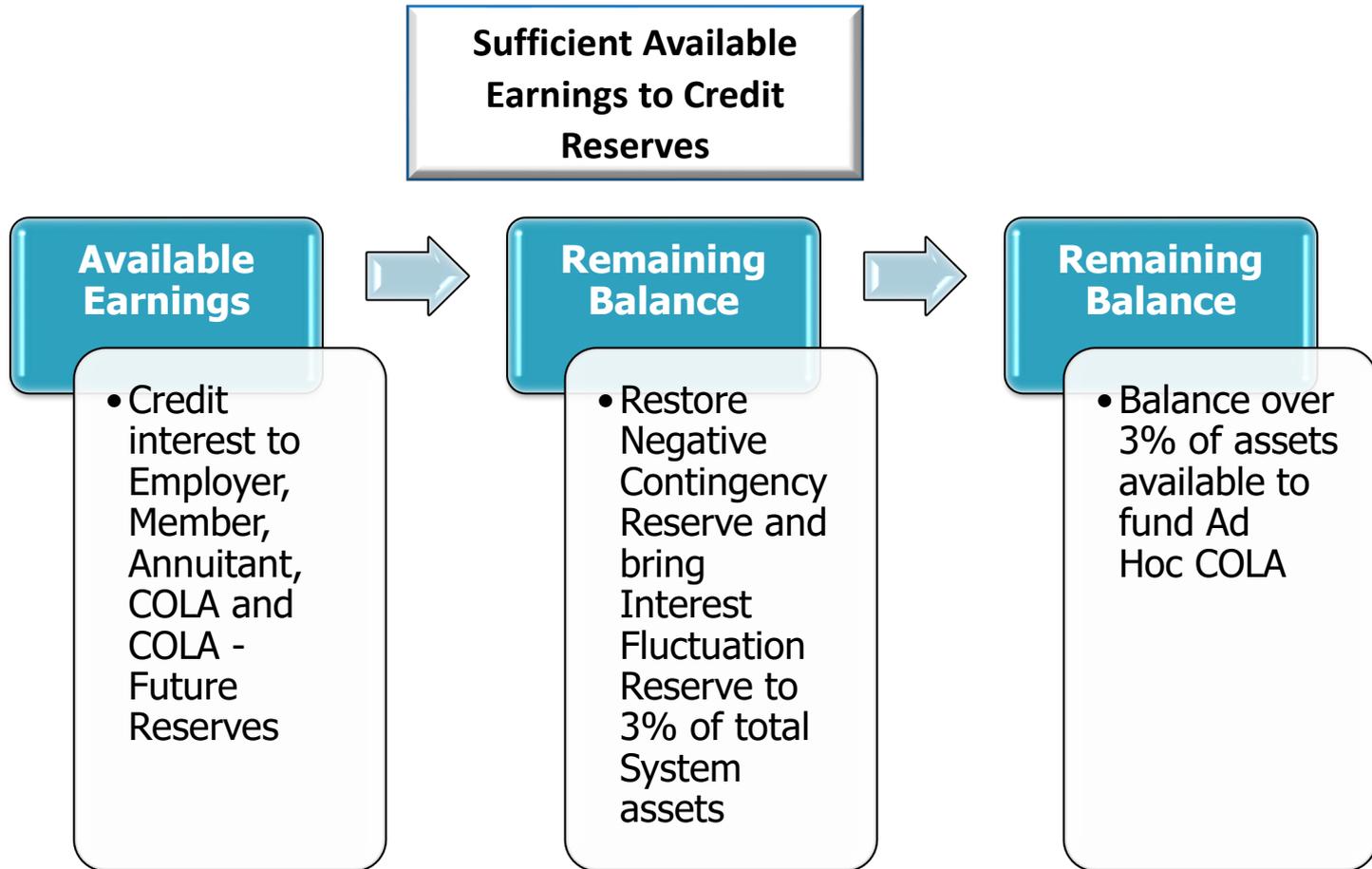


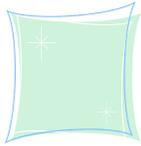
SCERA Negative Contingency Reserve

- 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%



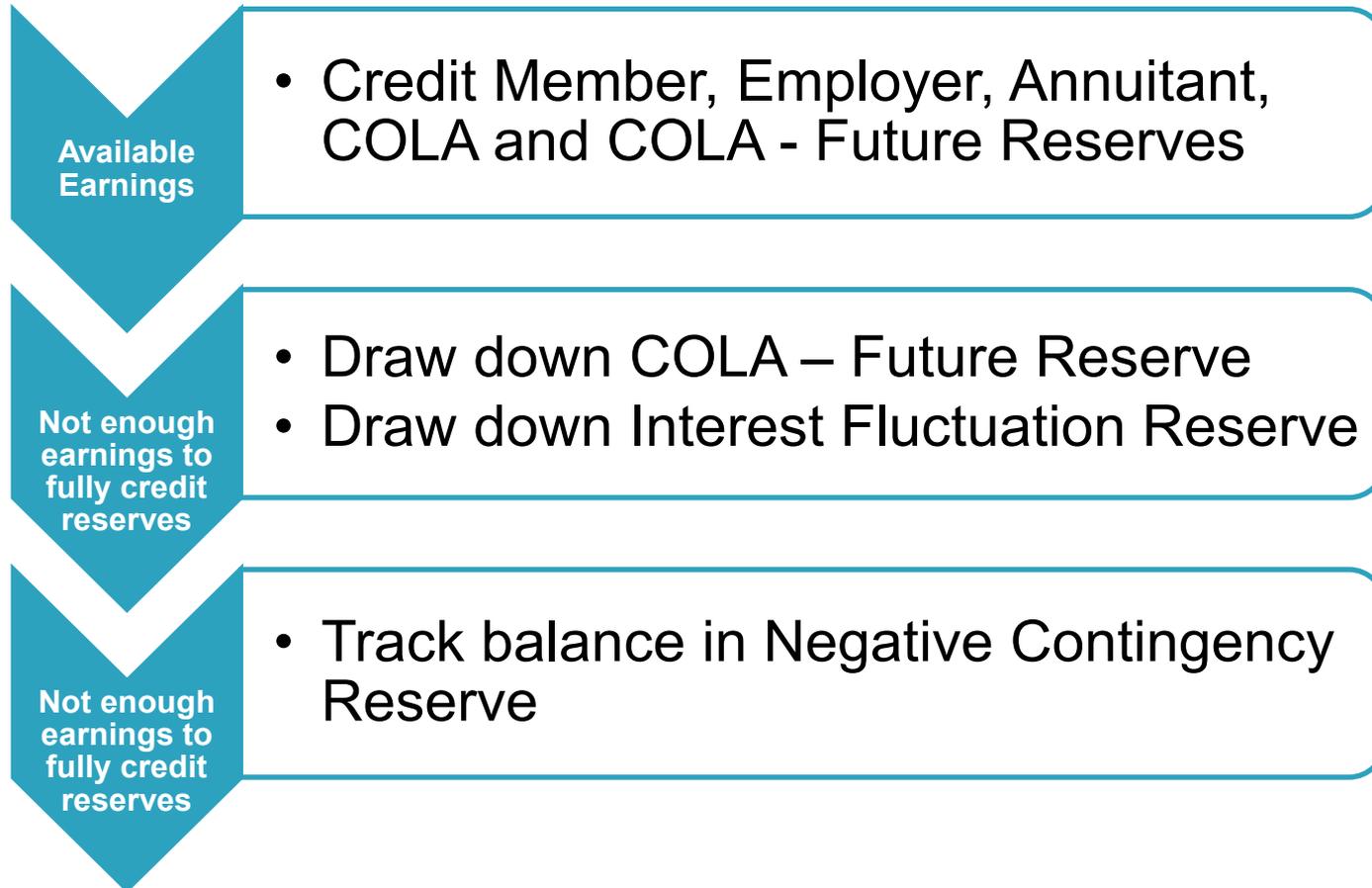
SCERA Negative Contingency Reserve

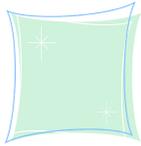




SCERA Negative Contingency Reserve

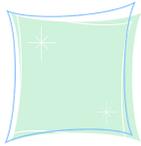
Insufficient Available Earnings to Credit Reserves





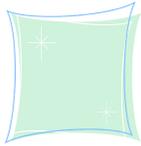
SCERA Negative Contingency Reserve

- 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



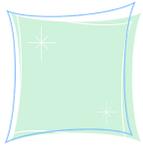
SCERA Negative Contingency Reserve

- **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

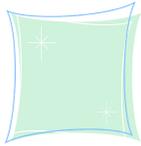
- 2008 – Available Earnings Shortfall
 - COLA – Future Reserve remains at zero
 - Interest Fluctuation Reserve balance (\$62 million) used to credit interest to reserves
 - Still a shortfall of \$46 million
 - \$46 million tracked in Negative Contingency Reserve



SCERA Negative Contingency Reserve

Negative Contingency Reserve Balance

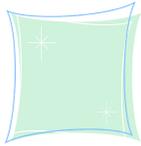
- 2009 -\$143 million
- 2010 -\$222 million
- 2011 -\$361 million
- 2012 -\$502 million
- 2013 -\$469 million
- 2014 -\$459 million
- 2015 -\$491 million
- 2016 -\$528 million
- 2017 -\$521 million
- 2018 -\$571 million
- 2019 -\$581 million
- 2020 -\$583 million
- 2021 -\$527 million
- 2022 -\$598 million



SCERA Negative Contingency Reserve

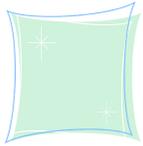
UAAL and Negative Contingency Reserve are not the same thing

- **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



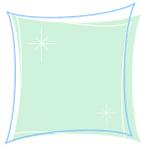
SCERA Negative Contingency Reserve

- 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