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MENDOCINO COUNTY
EMPLOYEES' RETIREMENT ASSOCIATION
625-B KINGS COURT
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Date: May 1, 2014
To: Board of Retirement
From: Tom Watson, Interim Retirement Administrator Tom Watson
Subject: Administrator's Report

Meetings attended since the last Board of Retirement meeting:
I met with the Audit and Budget Committee on Monday, April 21, 2014 at 10:00 a.m. with Crystal Ekanayake, Gallina Audit Partner, via teleconference (for information about Gallina's external audit services). The FY 2014 – 2015 Budget development was reviewed and changed to reflect the Committee's Proposed Budget to the Board of Retirement. The Committee will address these two items (Annual Budget and External Audit Services) later in the agenda.

All staff met on Tuesday, April 22, 2014 at 8:15 a.m. to review the recap of the Board of Retirement meeting; discuss the next Board of Retirement meeting agenda items; receive the first ever MCERA "Calendar of Events" (showing tasks throughout the month/year to be accomplished); receive the "Contract Service Provider Invoice Review Procedure;" get a Pension Gold project update; and receive member services (verbal) feedback.

On April 22, 2014, I (along with most Board of Retirement members) attended the Board of Supervisors' Strategic Planning Session on Financial Sustainability that focused on public employee pensions (also entitled "Pension Workshop"). This item was scheduled for 9:30 a.m. There were two presentations (one by financial advisor Rob Larkins and one by attorney Linda Ross). Many comments were made by citizens (a couple of whom were also members of the Board of Retirement). Members of the Board of Supervisors also made many comments. This was informational only at this time.

Pension Gold Benefits Administration Computer System:
The team of MCERA staff, County Information Services, Linea Solutions (the consultant) and implementation personnel of Pension Gold continue to work on the integration and further computerization of the benefits administration system. Deliverable #1 development and testing is about 20% complete with user testing to begin mid-June. There was a project status meeting held April 21, 2014. There is no monthly update due to the compressed timeframe between the April and May Board of Retirement meetings.

State Association of County Retirement Systems (SACRS) May 2014 Conference Update
Three Board of Retirement members will be attending the SACRS Conference the week after the Board of Retirement meeting: John Sakowicz, Tim Knudsen and Richard Shoemaker. John Sakowicz will be the MCERA Board voting representative to the SACRS Business meeting.

Distribution of Documents:
The final forms of the "Retiree Payroll Verification Procedures" and the amended "Audit and Budget Committee Charter" are being distributed to the Board of Retirement members with this report. The discussions and approvals were completed at the April 16, 2014 Board of Retirement meeting. These are for Board members' information and future reference only.

Report on Specific Questions from the April 16, 2014 Board of Retirement Meeting:
A question arose about the difference in the Investment Portfolio – Target Analysis Column A between the "Total Managed Funds" ($425,948,652) and the "Total Invested Funds" ($426,812,652) a difference of $864,000. Scott German, CPA confirmed that the difference is the current fair value of the real estate of 625 Kings Court ($864,000) which is not a "Managed Fund" but is part of the "Invested Funds" of MCERA. We have eliminated this difference in the report going forward and show only "Total Investments."

Greg Ungerman of Callan confirmed that Callan will provide an update on PIMCO at today's meeting.

Staff could not locate a report on Board members or staff actual costs related to training and conferences that showed the costs delineated for each Board member and staff. Judy Zeller did locate what appears to be "budget" amounts showing individual Board members and staff estimated expenditures for education/training/conferences (as well as meeting stipends for Board members who receive these) that would then have supported the annual budgeted amounts for such expenditures. A copy of that spreadsheet is included with this report.

I sent an e-mail to Segal actuaries on April 17, 2014 requesting a response about their thoughts or findings on: (1) the Report of the Blue Ribbon Panel on Public Pension Plan Funding; and (2) the 7% increase in employer liabilities/contributions to private sector defined benefit plans due to a new actuarial table showing increased ages of retirees (with any potential effects on public sector retirement plans and more specifically MCERA). Dirk Adamsen (who also cc:ed Paul Angelo and Andy Yeung) replied via e-mail to both questions on Friday, April 25, 2014 and a copy of his e-mail with his attachment entitled "American Academy of Actuaries ISSUE BRIEF" dated February 2014.

Pensions and Investments Magazine Article "Pace of pension reform…"
Given the recent "Pension Workshop" put on by the Board of Supervisors and the apparent desire to continue to reform public pensions, I am sharing this timely article with the Board of Retirement members (see the copy of the "Pensions and Investment" article from the April 14, 2014 edition with this report).

Public Records Act Request

MCERA received a Public Records Act request from a representative of the group "California Common Sense" of the 1996 to 2007 Comprehensive Annual Financial Reports (CAFRs) and the 1996 to 2007 Actuarial Valuations. Staff found that transmitting electronic files of the information requested was not practical (files were too large and were rejected as "spam"). Staff updated the web site with the information and the citizen was informed that the requested records were all now on the web site (well within the legal timeframe for response).

Mendocino County Employees' Retirement Association
Retiree Payroll Verification Procedures
Effective May 1, 2014

To help ensure appropriate payments to retired members, the following procedures are to be implemented by staff effective May 1, 2014.

The Senior Retirement Specialist and the Retirement Specialist II will independently prepare original calculations of monthly retirement allowances for newly retired members. The two will then discuss their independent calculations together to see if they are in agreement. They will discuss any discrepancies and resolve any differences. This same procedure will be used for calculations of member ledgers' balances. The Senior Retirement Specialist will input the retired member's information into the retiree payroll system in MUNIS. The Senior Retirement Specialist will enter the retired member's gross pay and deductions onto the Excel spreadsheet which is prepared each payroll cycle to ensure that the payment information coming from the MUNIS retiree payroll system is in balance. Upon the death of a retired member, the same processes will occur with independent calculations made by the Retirement Specialist II and the Senior Retirement Specialist with discussion of the independent calculations made and resolution between the two of any discrepancies. Upon the completion of the balancing of the retiree payroll, a copy of the Excel spreadsheet used for such balancing will be forwarded to the Retirement Administrator, the Financial/Investment Officer and the Administrative Assistant (for the names and statistics needed for the Board of Retirement agenda). The files of the newly retired members and deceased retired members will be forwarded to the Retirement Administrator or Financial/Investment Officer for final review. The Retirement Administrator or Financial/Investment Officer will pull a 5% sample of new calculations of retired members monthly retirement allowances and member ledgers' balances to insure that calculations are correct.

The Retirement Administrator or the Financial/Investment Officer will review the retiree payroll Excel spreadsheet and retired members' files to insure that the calculations made by the Senior Retirement Specialist and by the Retirement Specialist II agree and are reflected on the spreadsheet. The files are then forwarded to the Administrative Assistant for placing the names and public data on the Board of Retirement agenda. The Administrative Assistant will then file these for future reference and audit.

Ongoing, the Retirement Administrator or the Financial/Investment Officer will randomly pull ten files of retired members each month for ten months each year to insure that the payments being made to the retirees are correct. The random sampling will be made from retired members who retired before May 1, 2014. This review must be noted by date in the retired member's file and the retired member's name withdrawn from future random samplings.

These procedures will need to be reviewed and amended upon completion of the Pension Gold Software system that will integrate various automated systems currently in use by MCERA staff.

MENDOCINO COUNTY EMPLOYEES' RETIREMENT ASSOCIATION

AUDIT AND BUDGET COMMITTEE CHARTER
(As Amended April 16, 2014)

INTRODUCTION

1. The Board of Retirement has established an Audit and Budget Committee to assist it in overseeing the Audit and Budget functions within MCERA.

2. The Audit and Budget Committee will make recommendations on matters pertaining to the annual financial audit and budget of MCERA to the Board of Retirement.

3. The Board Chair will appoint four members of the Board to the Audit and Budget Committee and designate one member to serve as the committee chair.

DUTIES AND RESPONSIBILITIES

1. The Audit and Budget Committee will, from time to time, as determined to be in the best interest of MCERA:

   a. Examine and recommend to the Board for approval the objectives and scope of the annual financial Audit and Budget, including the audit plans of the external financial auditor, the duties and responsibilities of the external financial auditor, and the timing and engagement fee of the annual financial audit;

   b. Meet with the external financial auditor to review and discuss the annual financial statements;

   c. Review the findings of the external financial auditor and review of the Management Letter, and any response thereto;

   d. Recommend the approved annual financial statements to the Board of Retirement for approval;

   e. Meet at least annually with the Retirement Administrator to discuss the effectiveness of the internal financial and operational control policies and receive an independent Report of Review of Service Agreements;

   f. Review the engagement of the external financial auditor at least every three years and make recommendations to the Board as to the appointment or recruitment of the external financial auditor;

DUTIES AND RESPONSIBILITIES (continued)

g. Review the findings or comments of any regulatory agencies concerning financial statements or other information of MCERA;

h. Review the proposed fiscal year budget prior to presentation to the Board of Retirement

MONITORING AND REPORTING

1. The Audit and Budget Committee will:

   a. Review, at least every three years, the performance and independence of the external financial auditor, including the impact of any non-audit services performed for MCERA by the auditors, or any affiliate thereof, on such independence;

   b. Review any significant changes in accounting practices or policies that may have an impact on MCERA or the Fund;

   c. Report regularly and make recommendations as deemed appropriate.

2. The Committee will perform any other duties that are assigned to it by the Chair of the Board.

CHARTER HISTORY

1. This Charter was originally adopted by the Board of Retirement on February 20, 2013 and amended on April 16, 2014.

SCAL YEAR 2013/2014 OARD EDUCATION AND CONFERENCES	DESCRIPTION	Transportation	Hotels	Meals	Registration	Misc	Total
OARD OF RETIREMENT							
andy Goodman	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00
							$ -
m Knudsen	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00
	Meeting Stipend					$ 1,500.00	$ 1,500.00
ob Mirata	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00
	Meeting Stipend					$ 1,500.00	$ 1,500.00
ohn Sakowicz	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00
	Meeting Stipend					$ 1,500.00	$ 1,500.00
hari Schapmire	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00
Richard Shoemaker	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00
	Meeting Stipend					$ 1,500.00	$ 1,500.00
ohn McCowen	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00
Ted Stephens	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00
	Meeting Stipend					$ 1,500.00	$ 1,500.00
Craig Walker	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00
Lloyd Weer	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00
Board Member (1)	SACRS Public Pension Investment Program						$ 3,500.00
Board Member (4)	Callan Institute						$ 3,000.00
Board Member (1)	CALAPRS Principles of Pension Management						$ 3,000.00
							$ 35,000.00

FISCAL YEAR 2013/2014								
EDUCATION AND TRAINING		Transportation	Hotels	Meals	Registration	Misc	Total	Individual Totals
STAFF								
Richard White	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00	$ 4,350.00
	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00	
	Callan Institute						$ 750.00	
Jeff Berk	CALAPRS Roundtable	$ 160.00	$ 175.00	$ 75.00	$ 75.00	$ 15.00	$ 500.00	$ 500.00
Katy Richardson	CALAPRS Roundtable	$ 160.00	$ 175.00	$ 75.00	$ 75.00	$ 15.00	$ 500.00	$ 3,300.00
	CALAPRS Roundtable	$ 425.00	$ 350.00	$ 75.00	$ 75.00	$ 75.00	$ 1,000.00	
	SACRS Conference	$ 400.00	$ 1,000.00	$ 200.00	$ 120.00	$ 80.00	$ 1,800.00	
Judy Zeller	CALAPRS Roundtable	$ 160.00	$ 175.00	$ 75.00	$ 75.00	$ 15.00	$ 500.00	$ 3,000.00
	CALAPRS Roundtable	$ 425.00	$ 350.00	$ 75.00	$ 75.00	$ 75.00	$ 1,000.00	
							$ 1,500.00	
Christine O'Ferrell	CALAPRS Roundtable	$ 160.00	$ 175.00	$ 75.00	$ 75.00	$ 15.00	$ 500.00	$ 2,800.00
	CALAPRS Roundtable	$ 425.00	$ 350.00	$ 75.00	$ 75.00	$ 75.00	$ 1,000.00	
	CALAPRS Intermediate	$ 500.00	$ 350.00	$ 150.00	$ 200.00	$ 100.00	$ 1,300.00	
	Unallocated						$ 1,050.00	$ 1,050.00
						TOTAL	$ 15,000.00	$ 15,000.00

Thomas Watson - RE: Mendocino CERA BoR Actuarial Questions

From: "Adamsen, Dirk M." <dadamsen@segalco.com>
To: Thomas Watson <watsont@co.mendocino.ca.us>
Date: 4/25/2014 9:33 AM
Subject: RE: Mendocino CERA BoR Actuarial Questions
CC: "Yeung, Andy" <AYeung@segalco.com>, "Angelo, Paul" <pangelo@segalco.com>
Attachments: Public-Plans_IB-Funding-Policy_02-18-2014.pdf.pdf

Hi Tom -

Below we provide responses to the two Board of Retirement questions posed in your April 17, 2014 e-mail below. Our responses are as follows:

Q1. Thoughts/Response on the Report of the Blue Ribbon Panel on Public Pension Plan Funding (Trustee John Sakowicz brought the article with his own Executive Summary to present to the Board of Retirement at the meeting)

A1. The American Academy of Actuaries released another issue brief, this time from its Public Plans Subcommittee on the topic of Objectives and Principles for Funding Public Sector Pensions Plans (see attached document). Here are the key points shown on the first page of the document:

- The policies used to establish funding for a public-pension plan should be formulated to maintain an appropriate balance among the competing objectives of benefit security, generational equity, and contribution stability.

- Policymakers should communicate how these objectives have been balanced, and how, when and whether or not all of the identified costs are expected to be met via the contribution allocation procedure.

- The contribution-allocation procedure should include a funding target based on accumulating the present value of benefits for members by the time they retire, and a plan to make up for any variations in actual assets from the funding target within a reasonable time period.

- Any risks that could make it difficult to achieve the objectives should be identified, anticipated, and communicated, and the results of the contribution-allocation procedure should be monitored and adjustments made as necessary.

- The contributions determined by the contribution-allocation procedure should actually be contributed to the plan by the sponsor on a consistent basis.

The document is consistent with most other recent information on funding policies released by other organizations (including the CAAP, CCA and GFOA). The main additions here are the objective on benefit security and the principle on risk issues. The rest is not new but it is good to have it said by the Academy – especially the principle of "fund the actuarially determined contribution". In addition, we

believe that the MCERA funding policy is consistent with the points outlined in this document.

As you have heard, the Society of Actuaries (technically, a "Blue Ribbon Panel" of mostly non-actuaries convened by the SOA) also issued a report on funding policies and related disclosures. The funding policy objectives in that report are very consistent with what the other actuarial groups are saying. Unfortunately their new suggested disclosures are very different from any other proposals and to our view more burdensome than helpful. We are watching that development and may have more to say on it later on.

Q2. A Trustee heard or learned that there was a 7% increase in employer contributions to private sector defined benefit plans due to a new actuarial table showing increased ages of retirees. Will there be any similar effects on public sector retirement plans/MCERA?

A2. When reviewing actuarial assumptions for our clients, one of the retirement systems we typically monitor and reference is the California Public Employees' Retirement System (CalPERS). In January 2014, CalPERS issued an experience study report in which they recommended new actuarial assumptions. Among their proposed changes in assumptions were changes to the post-retirement mortality assumptions for healthy retirees (and beneficiaries) and for disabled retirees. The new assumptions reflect observed improvement in mortality, which leads to an increase in life expectancy. The new mortality tables proposed by CalPERS produced A/E ratios (which represent the actual number of deaths divided by the expected number of deaths) of roughly 125% overall. This means that CalPERS has built in about a 25% margin for future expected improvements in mortality. Note that the overall A/E ratio under the current mortality assumptions was about 99%, which means that CalPERS has proposed about a 26% improvement in overall mortality (i.e., from an A/E ratio of 99% to a ratio of 125%).

As you may be aware, we last prepared a triennial experience study report for MCERA in 2011 covering experience for the Association for the period from July 1, 2008 - June 30, 2011. At the time of the 2011 study, we indicated that Segal prefers to include at least a 10% margin for future expected improvements in mortality, in comparison to the roughly 25% margin recently proposed for CalPERS. This 10% margin was actually included for MCERA in 2011 for the mortality assumptions recommended by Segal when considering all groups (i.e., General, Safety and Probation), genders, and types of retirement (i.e., healthy retirees, disabled retirees, and beneficiaries) combined.

Later this year we will be performing an updated experience study for MCERA, covering the period from July 1, 2011 - June 30, 2014. This study will require the use of the June 30, 2014 valuation data, which is not expected to be sent by MCERA and reviewed by Segal until around the end of August or beginning of September. As such, we have not yet performed an analysis of MCERA's actuarial experience over the period from July 1, 2011 - June 30, 2014. Note, however, that we have performed numerous experience studies for other public retirement systems over the last several years. For some of these systems, we have observed improvements in mortality and have recommended changes to the mortality assumptions that reflect increases in future life expectancy. Note that we expect to have information related specifically to MCERA's mortality experience available around October, but before then it would not be possible to ascertain what impact, if any, mortality improvement may have on MCERA.

Please let us know if you have any further questions. Thanks.

- Andy and Dirk

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From: Thomas Watson [mailto:watsont@co.mendocino.ca.us]
Sent: Thursday, April 17, 2014 12:15 PM
To: Adamsen, Dirk M.
Subject: Mendocino CERA BoR Actuarial Questions

Dirk:

The Mendocino CERA Board of Retirement met yesterday and had some "actuarial" questions/requests for The Segal Company:

a. Thoughts/Response on the Report of the Blue Ribbon Panel on Public Pension Plan Funding (Trustee John Sakowicz brought the article with his own Executive Summary to present to the Board of Retirement at the meeting)

b. A Trustee heard or learned that there was a 7% increase in employer contributions to private sector defined benefit plans due to a new actuarial table showing increased ages of retirees. Will there be any similar effects on public sector retirement plans/MCERA?

Please pass these questions/requests on to Paul Angelo or Andy Yeung for response.

Thank you, Dirk!

Tom Watson, Mendocino CERA Interim Retirement Administrator

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AMERICAN ACADEMY of ACTUARIES
ISSUE BRIEF
FEBRUARY 2014

Objectives and Principles for Funding Public Sector Pension Plans

Key Points

- The policies used to establish funding for a public-pension plan should be formulated to maintain an appropriate balance among the competing objectives of benefit security, generational equity, and contribution stability.
- Policymakers should communicate how these objectives have been balanced, and how, when and whether or not all of the identified costs are expected to be met via the contribution-allocation procedure.
- The contribution-allocation procedure should include a funding target based on accumulating the present value of benefits for members by the time they retire, and a plan to make up for any variations in actual assets from the funding target within a reasonable time period.
- Any risks that could make it difficult to achieve the objectives should be identified, anticipated, and communicated, and the results of the contribution-allocation procedure should be monitored and adjustments made as necessary.
- The contributions determined by the contribution-allocation procedure should actually be contributed to the plan by the sponsor on a consistent basis.

Funding a pension plan involves determining appropriate contribution amounts at specific points in time and determining how to invest the assets of the plan until benefits are paid. In the private sector, minimum contribution requirements are set by federal law.[1] In the public sector, each state sets its own contribution requirements, and each local governing body (e.g., county, city, district) sets its own contribution levels within whatever requirements, if any, the state may have established for local jurisdictions. Decisions about what to contribute and when are usually made by a retirement board or plan sponsor within the boundaries of the contribution requirements noted above. The decision-making entity typically is advised by an actuary. In reality, there is wide variation in the policies adopted by different local governing bodies to fund their pension plans, reflecting a complex interplay between local legal or policy requirements, objectives, and other constraints or competing priorities. In recent years, there has been a great deal of public discussion about whether current policies are appropriate or prudent.

Since the Government Accounting Standards Board (GASB) issued Statements 25 and 27[2] in 1994, many local governing bodies, rating agencies, and other stakeholders have used the parameters in

[1]Employee Retirement Income Security Act of 1974 (ERISA) as amended.
[2]GASB Pronouncement No. 25: *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*; GASB Pronouncement No. 27: *Accounting for Pensions by State and Local Governmental Employers.*

The American Academy of Actuaries is an 18,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

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Don Fuerst, Senior Pension Fellow
David Goldfarb, Pension Policy Analyst

those pronouncements for determining the Annual Required Contribution (ARC) as a benchmark for contribution requirements.[3] In 2012, GASB issued Statements 67 and 68,[4] replacing Statements 25 and 27 effective for fiscal years beginning after June 15, 2013 and 2014 respectively, and it eliminated the ARC and clearly avoided providing guidance that might serve as a benchmark for contribution requirements.

Certain Actuarial Standards of Practice (ASOPs), as promulgated by the Actuarial Standards Board (ASB), identify what actuaries should consider, document, and disclose when performing an actuarial assignment, including, but not limited to, measuring pension obligations, selecting assumptions, and selecting methods to determine pension plan contributions. The guidance for selecting methods to determine pension contributions, however, is limited, focusing largely on ensuring there are adequate assets to pay benefits when due. Recognizing there are other objectives and issues in the public sector, the Pension Practice Council of the American Academy of Actuaries believes that a discussion of the fundamental objectives and principles for funding public-sector pension plans can inform actuaries practicing in the public sector, the decision-makers who set policies to fund pension plans, and the public at large as to some of the issues to consider in developing a funding policy.

Actuaries typically provide input with respect to the contribution allocation procedure and the assumptions used in that procedure to fund the pension plan. A contribution allocation procedure primarily consists of:

- an **actuarial cost method** that allocates the projected pension obligation among past, current, and future periods of service,
- an **asset smoothing method** that recognizes investment gains and losses over a period of time, and
- an **amortization method** that allocates the cost of benefit changes, assumption changes, and gains and losses over future years.

Although a plan's investment policy will affect the risks associated with a contribution allocation procedure,[5] the investment policy itself is generally not considered a component of the contribution allocation procedure.[6]

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[3]The ARC has been the basis for annual pension expense under GASB Statements 25 and 27. It was generally equal to the contributions determined for the plan provided the contributions fell within certain parameters. As a result, those parameters came to be viewed by some as guidance for appropriate contribution levels even though they were not intended to provide such guidance.

[4]GASB Pronouncement No. 67: *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25*; GASB Pronouncement No. 68: *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27.*

[5]One of the key points of the Academy's recent issue brief, *Measuring Pension Obligations*, was that "Plans funded at the budget level and invested in a diversified portfolio are likely to experience either insufficient or surplus assets, and benefit security is affected by the plan sponsor's ability to make additional contributions if an adverse investment experience materializes."

[6]It is intended that this issue brief will be supplemented in the future with a Practice Note for actuaries that discusses the elements of a contribution allocation procedure in more detail.

Members of the Public Plans Subcommittee include: Melissa Algayer, MAAA, FCA, EA; Paul Angelo, MAAA, FSA, FCA, EA; Brent Banister, MAAA, FSA, FCA, EA; William Hallmark, MAAA, ASA, FCA, EA (Chairperson); David Kausch, MAAA, FSA, FCA, MSPA, EA; Larry Langer, MAAA, ASA, FCA, EA; Matt Larrabee, MAAA, FSA, EA; Alan Miligan, MAAA, FSA, FCA, FCIA; Kim Nicholl, MAAA, FSA, FCA, EA; Mark Olleman, MAAA, FSA, FCA, EA; James Rizzo, MAAA, ASA, FCA, EA; Brian Septon, MAAA, FSA, FCA, EA; David Stimpson, MAAA, FCA, EA; Gregory Stump, MAAA, FSA, FCA, EA

Objectives

In establishing the policies used to fund a public sector pension plan, three primary objectives need to be balanced:

- Benefit Security
- Contribution Stability and Predictability
- Generational Equity

Benefit Security

Pension plans provide a form of compensation in which benefits are paid many years after the period of employment that entitled the recipient to those benefits. Consequently, it is important for plan members to be confident that the promised benefits will be paid. The key factors that determine the security of the pension promise are the legal obligation of a plan sponsor[7] to provide the benefit, the level of assets in the pension plan, the manner in which those assets are invested, and the financial resources of the sponsor to make any necessary additional contributions if and when those contributions come due. The policies established to fund the pension plan should be premised on the assumption that the obligation to provide the promised benefits must be met. Since the financial resources of a sponsor can change over time, the policies used to fund the pension plan should target the accumulation of sufficient assets over the working lifetime of a plan member, at least equal to the present value of the plan member's future benefits on a basis consistent with the level of risk affordable by the plan sponsor. The contribution allocation procedure should pay for any difference between actual and anticipated experience in some reasonable period of time that is not too long.[8]

Contribution Stability and Predictability

The annual contribution to a pension plan is a budgeted expenditure for the plan sponsor. Significant changes in the contribution amount from one year to the next can have significant repercussions on other parts of the budget, particularly if those changes require an increase that is not or cannot be anticipated. While benefit security may be best served by adjusting for adverse deviations from expected experience over a very short period, the volatility and lack of predictability in contribution amounts that can result (depending on the manner in which assets are invested) could be unsustainable. Consequently, investment strategy, benefit policy, and margins for adverse deviation in the selection of assumptions are considered to control the exposure to significant adverse changes in contribution amounts. The contribution allocation procedure should pay for any difference between actual and anticipated experience in some reasonable period of time that is not too short.8 The period selected should allow sponsors reasonable time to adjust to events that affect the contributions to the plan.

Generational Equity

From an economic perspective, each generation of taxpayers ideally should pay for the compensation of the public employees who provide services to those taxpayers, including the funding of pension benefits that accrues during the period. If all pension plan assumptions are met, the contribution allocation procedure should accumulate assets in an orderly manner to the present value of future benefits by the time a plan member retires.

Actuarial cost methods generally do a good job of allocating the expected cost of an employee's benefit in a manner consistent with the

[7] In a public pension plan, it is common for there to be multiple sponsors and in many cases these sponsors share the cost of providing pension benefits to the employees of all of the plan sponsors. In this issue brief, the word "sponsor" should also be interpreted as encompassing multiple sponsors.

[8] "Too long" and "too short" are subjective terms and are used here to emphasize the competition between these objectives. Improving benefit security requires that differences be made up over a relatively short period of time while improving contribution stability requires that differences be made up over a relatively long period of time.

objective of generational equity. The significant challenges to accomplishing the objective of generational equity arise when there are gains or losses (particularly on benefits and the assets intended to provide the benefits for former employees or retirees), assumption changes (again, particularly for inactive members), or prior generations that did not fully pay for the cost of the benefits for the employees who provided services to that generation.

Balancing the Objectives

Each of these objectives is important, but they naturally come into conflict at times. The policies used to fund the plan should seek appropriate balance among the conflicting objectives, and an appropriate balance is likely to differ from one plan (and sponsor) to another. Some plan sponsors may need more contribution stability than others (for example, plans may vary in terms of their size relative to the size of the sponsor resulting in different relative budget impacts for the same change in contribution amount). Different characteristics will cause decision makers to strike different balances among the competing objectives. However, no objective should be weighted to the exclusion of any other objective.

Principles

In balancing their objectives, plan decision-makers have a fair amount of flexibility. However, there are certain principles to which all policies should adhere, regardless of how the objectives are balanced.

Make the Contributions Determined by the Contribution Allocation Procedure

Given an investment policy and a set of assumptions, the contribution allocation procedure is used to determine the amount to be contributed at specific points in time. The procedure is designed to balance the above objectives and is premised on the assumption that the contributions that are determined will be made. If the determined contributions are not actually made on a consistent basis, some or all of the objectives will not be met. While there will always be competing demands for the cash needed to fund the pension plan, and while the contribution policies used may be modified or amended periodically to reflect updates to the balance between objectives, the resulting contribution determined by the process should not be ignored. The contributions called for by the contribution allocation procedure need to be made consistently by the sponsor.

Once the plan sponsor takes on a legal commitment[9] to provide retirement benefits, then ideally the plan sponsor should also be subject to a legally enforceable contribution demand of plan members to prefund the benefits on an actuarially determined basis. A failure to make the contributions determined by the contribution allocation procedure has contributed to many of the situations in which a pension plan is now placing significant strain on budgets.

Pre-Fund All of the Expected Costs

The contribution allocation procedure should include a funding target based on accumulating the present value of benefits for members by the time they retire, and a plan to make up for any variations in actual assets from the funding target within a defined and reasonable time period. Among other conditions, this means the following equation should hold true.

Current assets of the plan
+
Present value of future contributions intended to finance the benefits of current plan members
=
Present value of future benefits for current plan members

This equation implies that normal cost contributions for expected new entrants should not be planned to be used to pay for the benefits of current members. Of course, the future contributions should always be made before the ben-

[9]As determined by state and local authority.

efits need to be paid so the assets of the plan are not depleted before the last benefit payment is made.

Enhance Transparency, Accountability, Credibility, and Objectivity

The policies used to fund a pension plan should be clear in their intent and effect. In particular, the parties responsible for setting the policies should communicate how the objectives have been balanced, and, how, when, and whether or not all of the identified costs of the plan are expected to be met via the contribution allocation procedure. Appropriate disclosures should be developed to assist in this communication and allow users to track the effectiveness of the contribution policies over time. Furthermore, the disclosures should report on the actuarial valuation results both before and after any contribution volatility management techniques (including fixed contribution rates) to clearly identify the effect of recent volatility on current and anticipated future contribution levels and measures of unfunded liability.

Furthermore, even if the actual contribution is not based on an actuarially determined contribution (e.g., fixed contribution rates), the contribution amount should be compared to an actuarially determined contribution amount.

The parameters of the policies used to fund the pension plan should be developed based on balancing the specific policy objectives for the long term, rather than just on immediate contribution results.

Identify, Anticipate and Communicate Risk of Not Achieving the Objectives

In managing a pension plan, there are risks that could make it difficult to achieve the policy objectives. The sources of the risk (investment, demographic, agency, other) should be identified, anticipated, communicated, and monitored. Awareness of these risks can foster policies to mitigate the risks and improve the sustainability and ongoing affordability of the system.

For example, it is important to acknowledge, identify, and manage situations when stakeholders might seek to influence contribution amounts in the short-term to achieve competing goals (e.g., public policy funding for other public needs, immediate fiscal deficits, etc.) to the detriment of achieving the funding objectives for the pension plan.

Monitor Results and Adjust

A critical part of any contribution allocation procedure is periodic monitoring to assess the status of the plan and to make any adjustments warranted. If the contribution allocation procedure has not produced results as anticipated, or risks (anticipated or unanticipated) have emerged that may make it difficult to achieve the objectives, adjustments to the procedure should be considered to achieve the objectives of benefit security, generational equity, and contribution stability.

Summary

The policies used to fund a public pension plan should be formulated to maintain an appropriate balance among the competing objectives of benefit security, generational equity, and contribution stability. The policymakers should communicate how these objectives have been balanced, how, when and whether or not all of the identified costs are expected to be met via the contribution allocation procedure. The contribution allocation procedure should include a funding target based on accumulating the present value of benefits for members by the time they retire, and a plan to make up for any variations in actual assets from the funding target within a reasonable time period. Any risks that could make it difficult to achieve the objectives should be identified, anticipated, and communicated, and the results of the contribution allocation procedure should be monitored and adjustments made as necessary. Finally, and perhaps most importantly, the contributions determined by the contribution allocation procedure should actually be contributed to the plan by the sponsor on a consistent basis.

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Pension Funds

Pace of pension reform ebbs after 49 states change laws

Post-recession focus shifts to making DC plans mandatory

By HAZEL BRADFORD

As the flood of reform efforts aimed at public pension funds becomes a trickle, the main concern is whether the newfound fiscal discipline will hold.

While the sense of urgency has diminished, reform attempts have become a legislative staple, as public retirement systems continue to grapple with unfunded liabilities and political pressure to change.

The financial crisis and its aftermath sparked some kind of pension reform in every state except Idaho. Now "it appears to be the slowest pace of reforms since 2008," said Keith Brainard, Georgetown, Texas-based research director of the National Association of State Retirement Administrators. In a study of 32 plans in 15 states representing 65% of participants in its public plans database, the Center for Retirement Research at Boston College found most already have taken steps to reduce future pension costs by some combination of increasing employee contributions, raising age and tenure requirements, trimming salary calculation formulas used to set pension levels and shrinking or stopping cost-of-living increases.

Surprisingly, while reform debates were often seen as taking a page from the private sector and moving away from defined benefit plans, research due later this spring from the center will show less activity than expected. CRR researchers

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Jodi Hilton/The New York Times

COST-CUTTING: Alicia Munnell said the savings will be realized over the long term.

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found that just 15% of public plan sponsors introduced some form of defined contribution plan after 2008, compared with 20% pre-crisis.

A key distinction of the post-recession approaches to DC plans is their mandatory nature, unlike earlier moves that gave employees the option of having a DC plan. Six states — Georgia, Michigan, Rhode Island, Utah, Tennessee and Virginia — shifted to a mandatory hybrid plan since 2008, while Kentucky and Kansas went the cash balance plan route. Louisiana tried to mandate DC participation but was blocked by the courts after participants sued. Only Michigan and Alaska require new hires to participate solely in a defined contribution plan.

Many of the reforms to date have focused on newly hired workers. Those savings will take longer to realize, "but in the long run these cuts are going to get the costs below what they were before the recession," said Alicia Munnell, director of the retirement research center. "That does take care of the criticism that they can't afford DB."

In terms of reform attempts, the National Conference of State Legislatures found 29 states saw 166 pension bills introduced in 2014 alone, many of which addressed minor changes or proved too controversial to survive. One of the most high-profile reform bids came from Chuck Reed, the mayor of San Jose, Calif., who sought a voter referendum to allow local governments to renegotiate pension benefits for public employees. That bid was defeated in court last month.

Alive in just a few states

With many state legislative bodies already adjourned for the year, major pension reform is alive for now in just a few states: Lawmakers in Florida and Oklahoma are considering a shift to DC plans only for newly hired workers; in Pennsylvania, Gov. Rick Corbett is pushing the idea of a hybrid plan.

But the political prospects in all three states are far from certain.

One big reason things have gotten quieter is the improving economy.

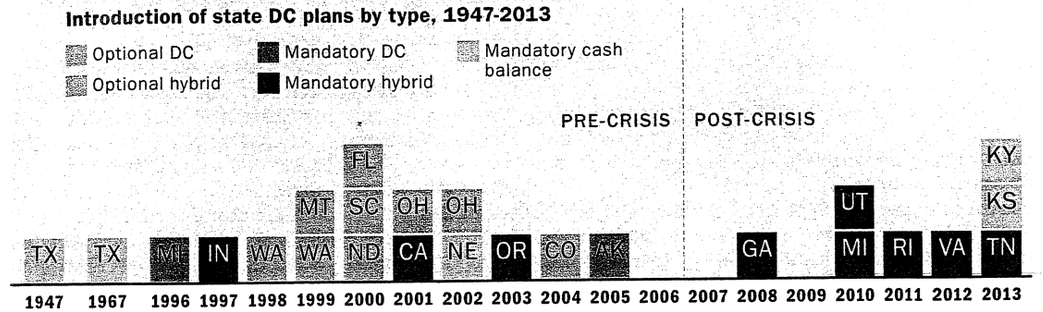
Wilshire Consulting, a unit of Wilshire Associates Inc., Santa Monica, Calif., found the aggregate funding ratio of 134 state defined benefit plans reached 75% in the fiscal year ended June 30, thanks largely to strong global equity markets that saw pension fund assets growing faster than liabilities.

The U.S. Census Bureau found that the 100 largest public pension funds reached their highest combined asset levels in 2013 since its first survey in 1968. Assets reached $3.192 trillion last year, a 12.5% increase from 2012.

For many public pension plans, investment losses since 2008 are just making their last appearance on balance sheets, but recent investment gains haven't been booked yet. Reforms passed in recent years should be given time to work before judging plans' ongoing health, say public pension experts.

SERIOUS ABOUT REFORM: David Draine said more policymakers are committing themselves to 'good pension funding practices' and making changes as needed.

Optional no longer State plans created post-crisis are all mandatory plans.



Sources: "An Update on Defined Contribution Plans in the Public Sector" by Alicia H. Munnell, Jean-Pierre Aubry and Mark Cafarelli, which references various actuarial valuation reports and websites of state legislatures

While some of the most recent reform efforts were driven by ideology, in other cases "it has been an effort to simply not pay for years of underfunding" or to avoid other spending cuts, said Steven Kreisberg, director of collective bargaining for the American Federation of State, County and Municipal Employees, Washington.

"We are seeing a few governors going back to the well out of political desperation. Beyond that, there's not much new or different."

Jordan Marks, executive director of the National Public Pension Coalition in Washington, whose members include public-sector unions, said: "There's no question that we are seeing public pension funds on the mend, but we'd be doing a lot better if politicians made their payments."

David Draine, senior researcher with Pew Charitable Trust's Public Sector Retirement Systems Project, Washington, said he's seen recent improvement, with some legislatures passing laws or even amending state constitutions to ensure pension payments are made, regardless of who is in office.

Commitment

"What you're seeing is a commitment by policymakers to good pension funding practices. There's no single thing that will absolutely guarantee fiscal discipline, but policymakers are understanding that they need to pay pension bills," said Mr. Draine.

"We need to be serious about funding these plans," agreed Ms. Munnell. "You can either pay it off in a systematic fashion, or not, but these amounts are going to be paid."

One new wrinkle in 2014 that could dampen recent improvements is Governmental Accounting Standards Board rules that will, for the first time, add another number to the political equation: net pension liability. Until now, public pension fund executives focused on their actuarially required contribution when setting annual pension funding targets.

Adding a system's total unfunded liability, instead of just the current amount due, to its financial reports will make an underfunded plan look worse, and even a relatively well-funded one look less so. "I worry about losing the ARC," said Ms. Munnell. "After the new GASB kicks in, it will just be harder to judge whether sponsors are doing a good job."

Dana Bilyeu, Salt Lake City-based executive director of the National Association of State Retirement Administrators, is optimistic. "Change is inevitable because we live in a different world today since 2008. But the basic pillars of plan design — mandatory participation, shared financing, benefit adequacy, pooled investment and longevity risks, and lifetime benefit payouts — have not changed," she said.