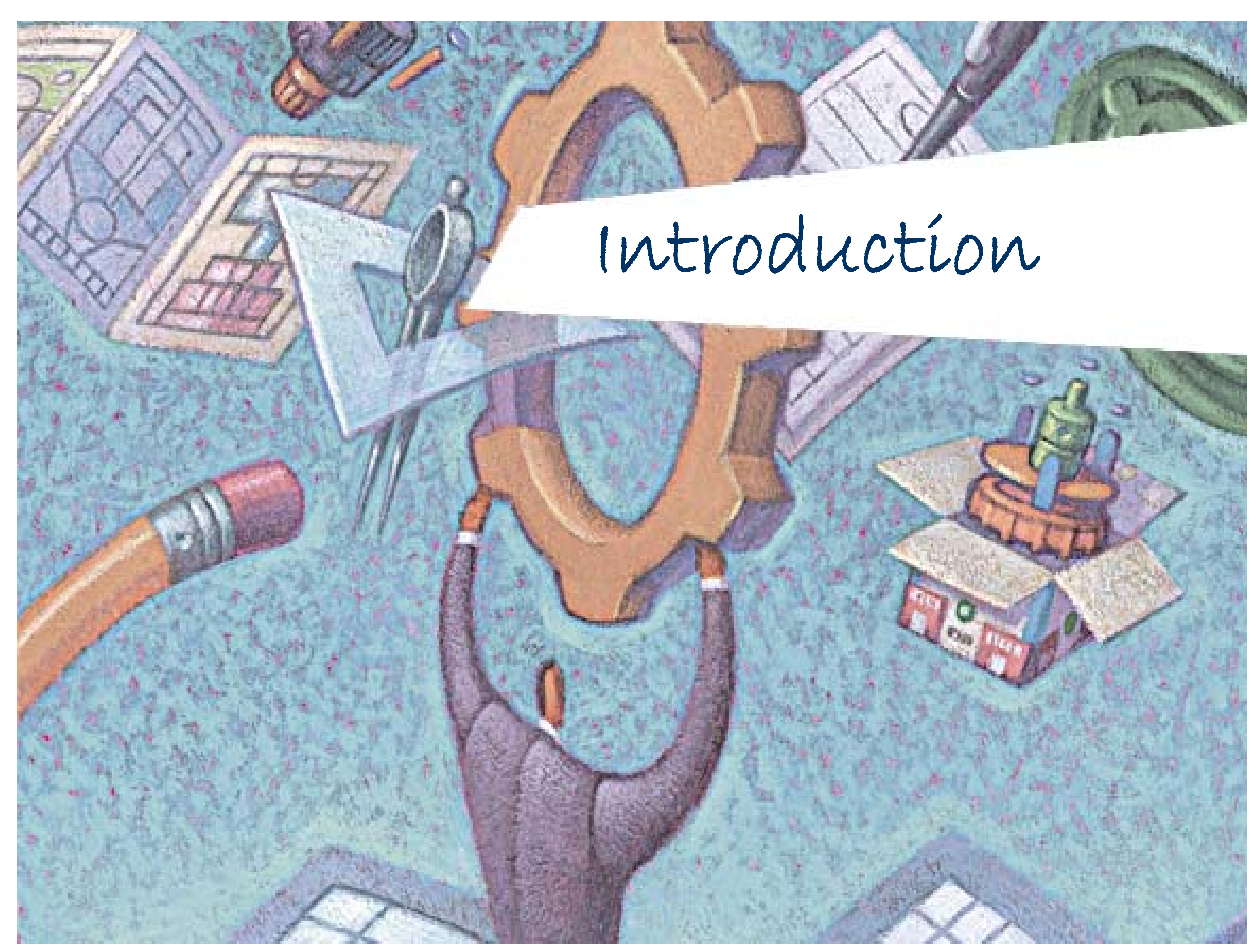
April 7, 2009
Joint Meeting:
Board of Supervisors and
Board of Retirement

Managing Pension Costs

County Presentation Agenda

- **Pension Requirements & Budget Impacts**
  - Susan Paul, Jason Stilwell
- **County Guiding Principles – Decision Impacts**
  - Jason Stilwell, Bill Hallmark
- **Actuarial Methods Limitations in Controlling Costs**
  - Bill Hallmark
- **Policies and Strategies that Affect Costs**
  - Susan Paul, Bill Hallmark


Introduction

Introduction

- The fundamental framework of the Retirement Program includes three key policy areas:

Benefits Policy

Retirement Program

Funding Policy

Investment Policy

Benefits Policy

- Controlled solely by the BOS
- Affects long-term cost of plan for employees and the County
- Is part of an employee's Total Compensation

Defines:

- The level of benefit – how much is paid
- When benefits are paid
- How long benefits are paid
- Options available to members

Retirement Program

Retirement Program

Investment Policy

- Controlled by the Board of Retirement
- Affects long-term cost of the plan for employees and County
- Affects expected investment return

- Determines volatility on investment returns
- When the results of the Investment Policy conflict with the County's pension benefit Guiding Principles, the County has to make adjustments to policies within its purview

Retirement Program

Funding Policy

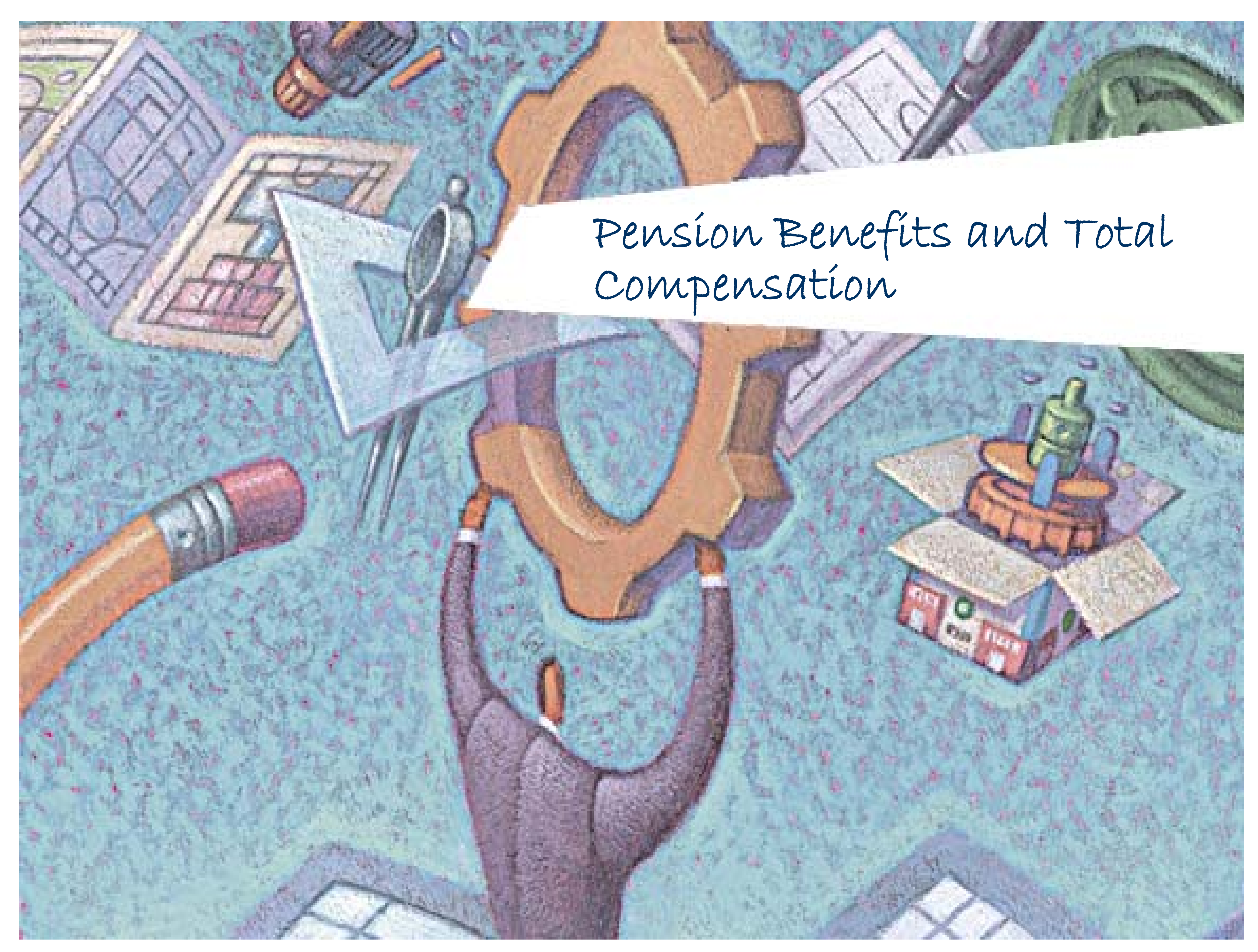
- Controlled by the Board of Retirement
- Does not affect long-term cost of plan, but does impact level of employee contribution
- Determines timing of contributions and cost recognition

- Includes all actuarial methods and assumptions
- When the results of the Funding Policy conflict with the County's pension benefit Guiding Principles, the County has to make adjustments to policies within its purview

Importance of the County's Guiding Principles

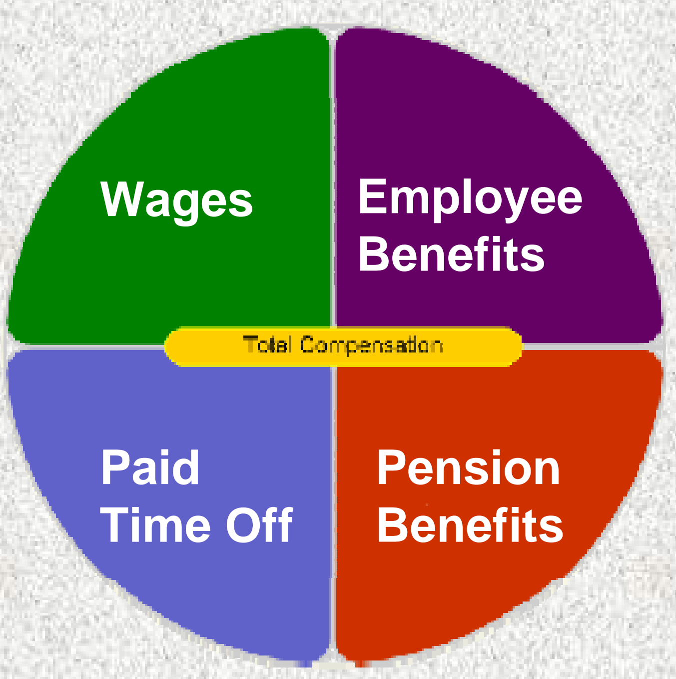
- Guiding Principles provide the framework for the County to make policy decisions within its purview when Board of Retirement policy decisions impact the County's budget.

- Guiding Principles set the framework for the County's overall Benefits Policy.


Pension Benefits and Total Compensation

Pension Benefit and Total Compensation

- **Total Compensation includes things such as:**
  - **Hourly wages and other forms of pay**
  - **Paid time off**
  - **Employee benefits (health care, life insurance, disability insurance, etc.)**
  - **Pension benefits**



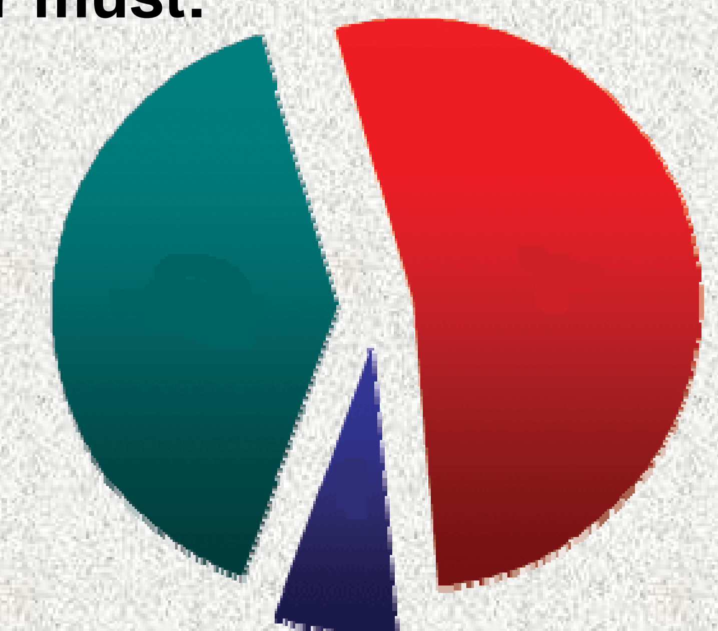
- **Part of the employment contract necessary to attract and retain talent**

Pension Benefit and Total Compensation

- All Total Compensation-related costs must be managed within an organization’s available financial resources
- Must be balanced with all other organizational costs
- Must be sustainable
- Organizational policy and Board direction dictates the amount of funds available within the County’s budget for negotiating Total Compensation for its workforce

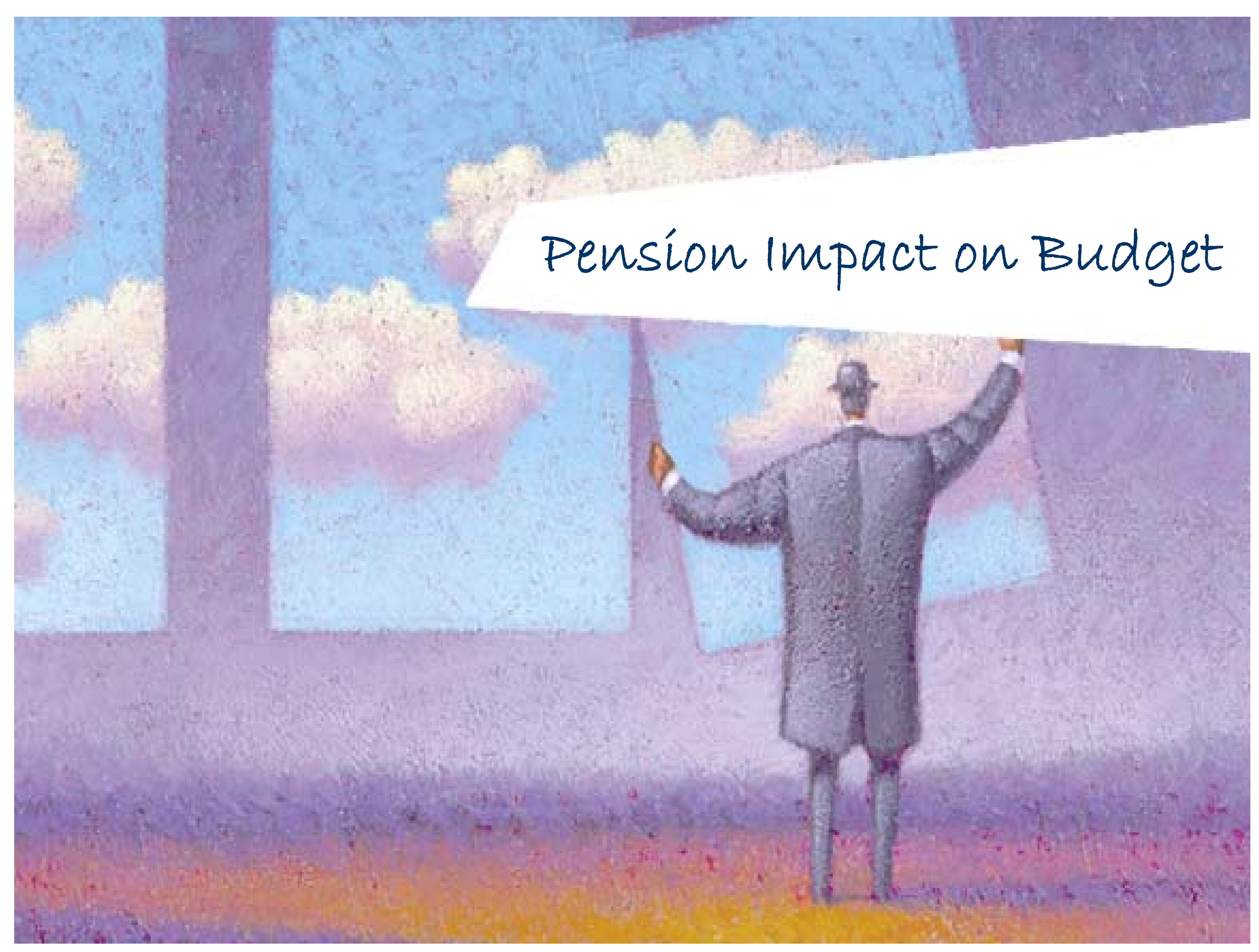
Pension Benefits and Total Compensation

- Only so much of the County's budget can be committed to Total Compensation – the remainder must be used to run operations and provide services
- When one part of Total Compensation becomes too costly, the employer must:
  - Examine the % of budget committed to pay workforce costs
  - Consider changes to its pay and benefits structure to stay within the available financial resources (budget)



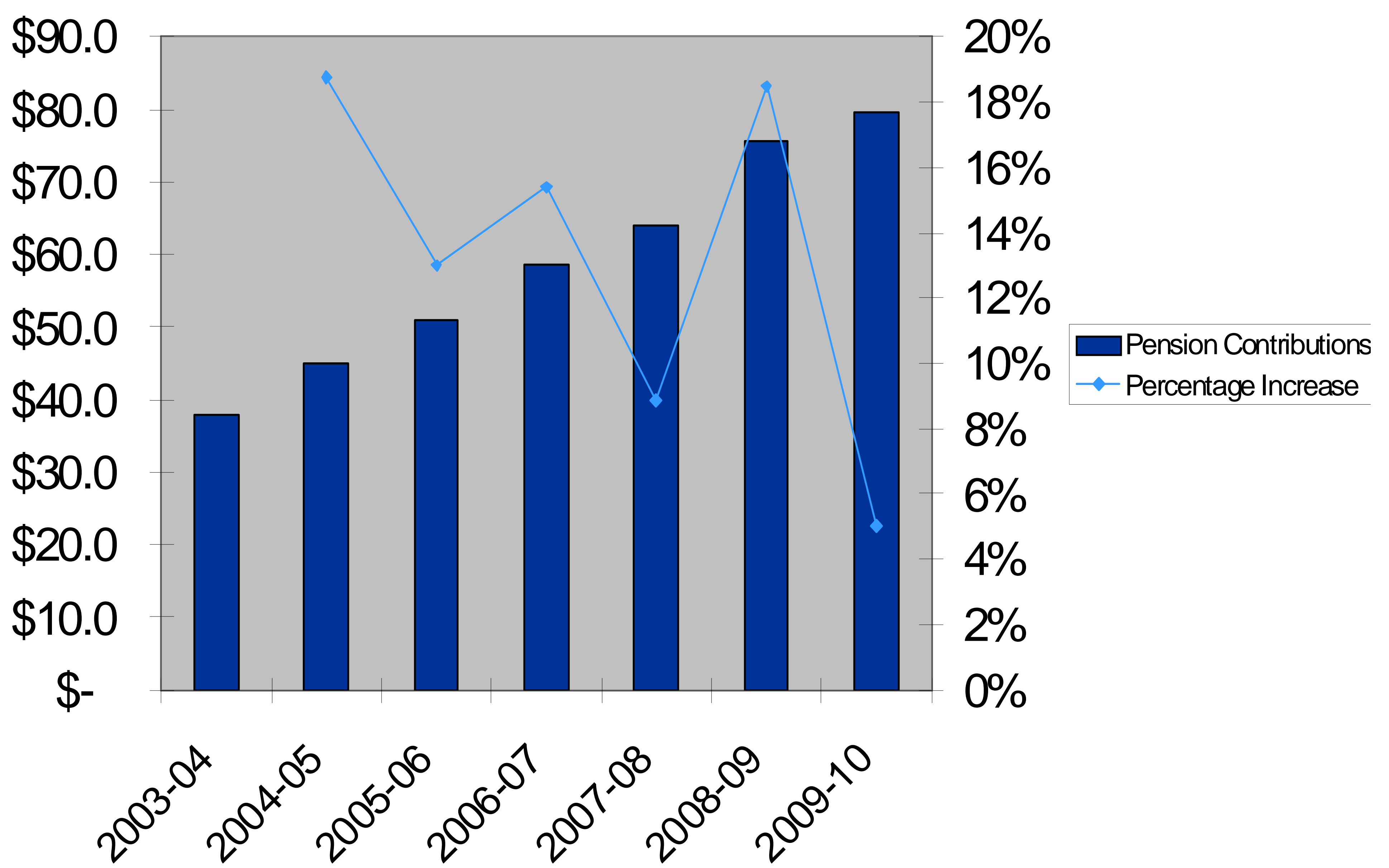
Pension Benefits and Total Compensation

- **Projected increases in retirement costs indicate that costs will grow beyond the County's ability to fund and sustain pension obligations along with all other aspects of Total Compensation**


Pension Impact on Budget

Pension Contributions

- Since FY 2003-2004, employer pension costs have increased steadily between 5% to 19% each year
- From FY 2007-2008 to FY 2008-2009, the increase was 18%
- The FY 2009-2010 cost is expected to increase $3.8M or 5%



Pension Contributions ($millions)
$90.0
$80.0
$70.0
$60.0
$50.0
$40.0
$30.0
$20.0
$10.0
$-
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
2003-04
2004-05
2005-06
2006-07
2007-08
2008-09
2009-10
Pension Contributions
Percentage Increase

Proportion of Budget Devoted to Pension Contributions

- **Pension cost increases play a significant role in budget increases**
- **Pension contribution as a percentage of expenditure budget has grown from 6% to 10%**
- **Expenditure budget has increased on average between 3% to 5%**

$900.0
$800.0
$700.0
$600.0
$500.0
$400.0
$300.0
$200.0
$100.0
$-

12%
10%
8%
6%
4%
2%
0%

2003-04
2004-05
2005-06
2006-07
2007-08
2008-09
2009-10

Expenditures
Pension % Of Expenditures

Pension Cost Increases Impact Service Levels

- $11.8M or 18% increase from FY 2007-2008 to 2008-2009 (plus $2m OPEB) required all Departments to make a total of $13.7M in reductions and reduce 83.43 FTEs as outlined and described in FY 2008-2009 Operating Plan (pages A-34 – A-39)
- For FY 2010-2011 the potential contribution rate of 39.37% would result in a $54.9M or 69% increase

Following is the County's schedule for Fiscal Year 2010-2011 Budget Activities:

- **June -** **Budget Hearings**
- **July -** **Load Adopted Budget**
- **August -** **Budget Improvements**
- **September -** **Capital Plan**
- **October -** **Develop Budget Principles**
- **November -** **BOS Adopts Budget Principles**

County's Maximum Long-term Sustainable Contribution Rate

- **Board of Supervisors determination:**
  - **The current rate has resulted in ongoing reductions in service**
  - **The true impact will not be apparent for years**
  - **Shift in funding from services to benefits**
  - **Retirement rates have and will continue to be absorbed in the County's balanced budget**

Importance of Policies to Improve Long-term Predictability

- Predictability is key for sustainability
- Large rate fluctuations result in service and labor disruptions
- Five-year forecasting is more accurate with formal policies
- Receiving rates in time to include in budget development enhance ability to manage the financial fluctuations on an annual basis

County Guiding Principles
– Decision Impacts

Draft Guiding Principles for County

- As an outcome of the February Board of Supervisors meeting, the Board requested that County staff and Mercer develop draft Guiding Principles for Board consideration
- Six principles have been developed to clarify the County's objectives regarding its participation in SBCERS
- Board of Supervisors determines the appropriate Guiding Principles for the organization
- Guiding Principles set the framework for the County's Benefits Policy and are designed to help the County manage the costs and risks associated with providing pension benefits and communicating to SBCERS for their consideration

Draft Guiding Principles for County

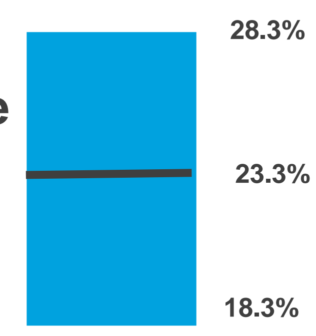
- **Expected median long-term contribution rate:**
  - The median contribution rate over a long period should equal:

Normal Cost Rate

+

Amortization Rate on Benefit Changes

- **Controlling annual change in contribution rate**
  - The change in the County's contribution rate should be limited to less than 5% of payroll per year except in rare circumstances.



Draft Guiding Principles for County

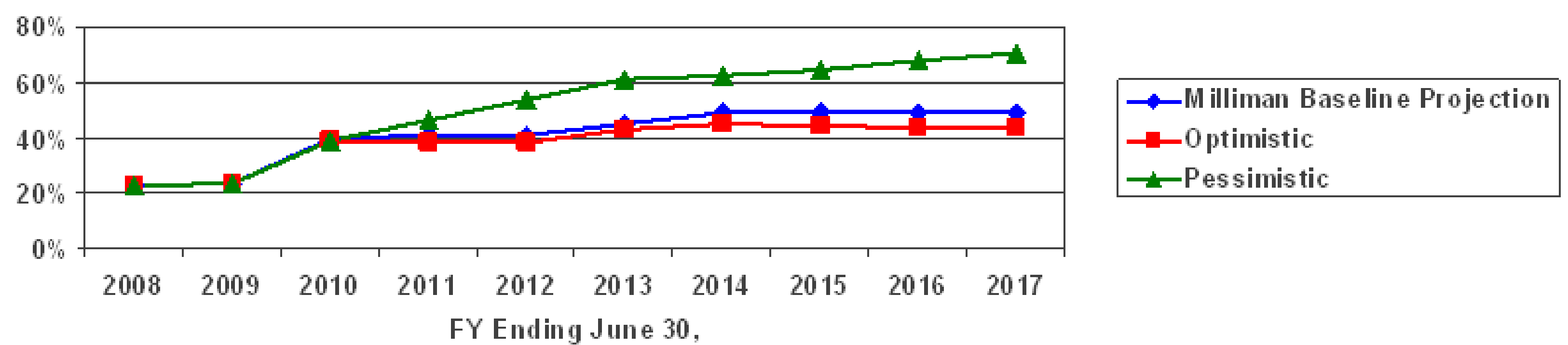
- County's maximum long-term sustainable contribution rate is 30% of payroll.
- Preservation of generational equity and funded status
  - The shortest possible amortization period consistent with the prior principles should be adopted.

Draft Guiding Principles for County

- Add market value of assets disclosures for:
  - Funded status (Projected to be 54% as of 6/30/2009)
  - UAAL (Projected to be $1.0 billion as of 6/30/2009)
  - Contribution rate (depending on method)
- To improve long-term predictability, the Retirement Board should be encouraged to adopt formal policies regarding
  - Excess earnings,
  - The contingency reserve, and
  - Any other reserves that may be used for purposes other than funding the primary pension benefits.

Limitations of Actuarial Methods
in Controlling Costs

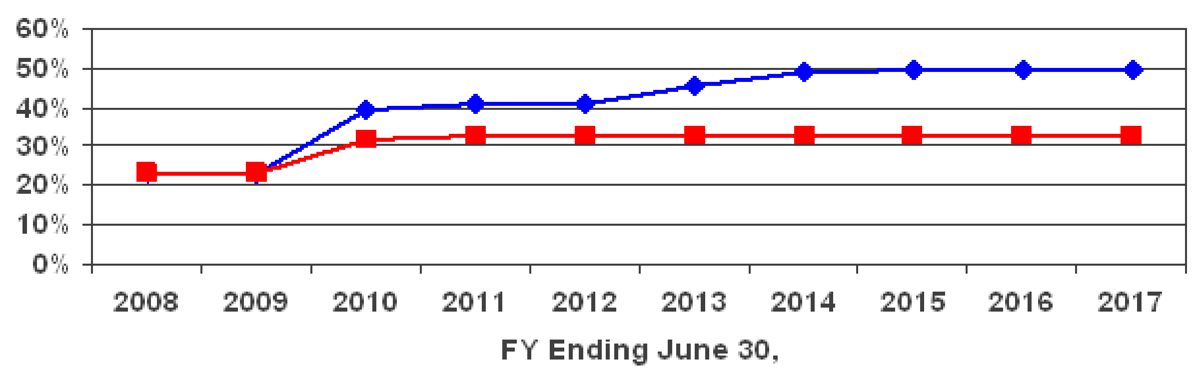
Limitations of Actuarial Methods
Projections under current methods



- As illustrated by Milliman's projection assuming -30% for the year ending 6/30/2009 (blue line above), the County's contribution rate is expected to rise rapidly
- Additional economic scenarios illustrate the variability around the baseline projection if asset returns are different than the assumed rate of 8.16%. No probabilities are attached to these scenarios.
  - Optimistic – Assumes three years of strong asset returns (approximately 20% domestic equity, 15% international equity, 1% bond), then reversion to assumed rate of 8.16%
  - Pessimistic – Models "lost decade" scenario (3 years of approximately -24% domestic equity, -7% international equity, and 3.5% bonds, then about 4% for the remainder of the decade)
- Even under an optimistic scenario, the contribution requirements increase significantly

Limitations of Actuarial Methods
Projections under alternative methods

- There are limits to what can be achieved by changing actuarial methods
  - Can delay the increase in contribution rates
  - If market improves, the delay may avoid some higher contribution rates
  - If market doesn't improve or gets worse, the delay can lead to even higher contribution rates in the future
  - The amortization period is limited to no longer than 30 years. If all assumptions are met in the future, the lowest long-term rate is the 30-year amortization shown by Milliman



Limitations of Actuarial Methods
Outlook compared to guiding principles

- Once a “highest sustainable contribution rate” is selected, the maximum ratio of market value UAL (MV-UAL) to payroll the sponsor can tolerate can be calculated
  - ’37 Act requires plans to amortize UAL over 30 years or less
  - The calculation of the maximum MV-UAL to payroll ratio assuming a 30-year amortization is illustrated below
- If the MV-UAL to payroll ratio equals the maximum, there is a 50% chance the long-term contribution rate will exceed the “highest sustainable contribution rate” defined by the sponsor

1. Max Sustainable Contribution Rate	30%	35%	40%
2. Employer Normal Cost Rate*	14%	14%	14%
3. Contribution available for UAL *(1.-3.)*	16%	21%	26%
4. 30 year amortization factor*	18	18	18
5. Max MV-UAL to Payroll ratio *(3. x 4.)*	288%	378%	468%

*Calculated assuming 8.16% interest and 4.00% payroll growth, consistent with 6/30/2008 valuation assumptions

Limitations of Actuarial Methods
Outlook compared to guiding principles

- Milliman's projection using a -30% return for the year ending 6/30/2009 projects a MV-UAL to payroll ratio of approximately 325%.
- This amount already exceeds the tolerance guideline proposed of a maximum sustainable contribution rate of 30% of payroll. That is, there is a greater than 50% chance that the long-term contribution rate will exceed 30% of payroll.
- Ideally, the probability of exceeding the MV-UAL to payroll ratio guideline would be significantly less than 50%.
- The County should consider either adjusting its long-term expectations for the maximum sustainable contribution rate or other policy options to limit its contribution requirements to SBCERS.

Policies and Strategies
Affecting Costs

Benefits Policy

- Compensation and benefits are negotiated with labor organizations for all represented employees
- The only way any aspect of Total Compensation can be changed for represented employees is through the collective bargaining process
- Ultimately, any changes to the County’s Benefits Policy are controlled by the County Board of Supervisors
- In addition, certain pension-related benefits are governed by law and require enacted legislation to change them

Other Policies and Strategies Affecting Cost

- **Investment Policy**
  - The System's investment policy affects both the County's expected contributions and the level of risk the County bears. Much of the ongoing risk retained by the County is investment risk. Higher investment returns will reduce required County contributions and lower returns will increase required County contributions
  - The investment policy decision belongs to the SBCERS Board

Other Policies and Strategies Affecting Cost (cont)
Pension Obligation Bonds (POBs)

- Under a POB, a plan sponsor elects to issue bonds and invests the proceeds in the pension trust
  - Reduces the plan's UAL (and thus the pension contribution rate), but creates repayment cost for the bonds issued
- Borrowing at a low, certain interest rate to invest at a higher, uncertain expected rate of return clearly has an expected positive value to the borrower, but carries commensurate investment risk
  - Effect is to increase leverage for the plan sponsor (similar to investing on margin)

MERCER

Other Policies and Strategies Affecting Cost (cont)
Pension Obligation Bonds (POBs)

- Assume a plan with $2 billion in liabilities and $1 billion in assets issues a POB for $1 billion to fully fund the pension plan. The POB will be repaid at 5%.
  - The sponsor now has $2 billion invested in the pension trust, while they have net assets of only $1 billion ($2 billion in the trust less $1 billion liability for POB)
- The table below shows the effect of the POB leverage on the total return for the first year to the sponsor (pension investment earnings less interest cost of bonds)
- As the bond is repaid, the amount of leverage decreases.

Market Rate of Return	Earnings on Pension Trust	POB Interest	Net Earnings	Sponsor's Net Rate of Return
16%	$320 M	($50 M)	$270 M	27%
8%	$160 M	($50 M)	$110 M	11%
0%	$0 M	($50 M)	($50 M)	-5%

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