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December 6, 2012

Board of Retirement
Santa Barbara County Employees' Retirement System

Re: Analysis of Assembly Bill 340 (PEPRA)

Dear Members of the Board:

As requested, we are providing an actuarial analysis of Assembly Bill 340 (AB 340), which includes the California Public Employees' Pension Reform Act of 2013 (PEPRA). This legislation, which was recently signed into law, revises the benefits available to any member of a California public retirement system (with a few exceptions) who enters the system on or after January 1, 2013. Under the provisions of this legislation, post-2012 new entrants will be placed into "new" plans with PEPRA compliant benefit formulas, compensation limitations and specific employee cost-sharing provisions.

The purpose of this analysis is to calculate the member and employer contribution rates effective January 1, 2013 for new entrants. Note that in certain cases, such as when a new hire has reciprocity, the member may be eligible to enter the applicable current plan and not be subject to PEPRA.

Our analysis is based on our review of the legislation and conversations with SBCERS staff. We strongly recommend that our understanding, as presented in this letter, is reviewed by SBCERS staff and legal counsel for consistency with the legislation.

Summary Results

The following chart shows the recommended contribution rates for the new plans effective January 1, 2013.

Recommended Contribution Rates Effective January 1, 2013 for New Entrants			
	General Members	APCD	Safety Members
Total Normal Cost Rate	13.88%	14.14%	26.31%
Member Contribution Rate	(7.00%)	(7.00%)	(13.25%)
Employer Normal Cost Rate	6.88%	7.14%	13.06%
UAAL Contribution Rate	16.47%	20.26%	25.82%
Employer Contribution Rate	23.35%	27.40%	38.88%

* Please see the section in this letter titled *Potential Adjustment to Employer Contribution Rates for special adjustments to consider in the payment on the UAAL contribution rates.*

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The following chart shows the recommended contribution rates for the new plans for the fiscal year 2013 - 2014.

Recommended Contribution Rates Effective July 1, 2013 through June 30, 2014 for New Entrants			
	<u>General Members</u>	<u>APCD</u>	<u>Safety Members</u>
Total Normal Cost Rate	13.88%	14.14%	26.31%
Member Contribution Rate	<u>(7.00%)</u>	<u>(7.00%)</u>	<u>(13.25%)</u>
Employer Normal Cost Rate	6.88%	7.14%	13.06%
UAAL Contribution Rate	<u>18.07%</u>	<u>22.06%</u>	<u>30.97%</u>
Employer Contribution Rate	24.95%	29.20%	44.03%

For new Safety members, the normal cost rate is based on the formula referred to in AB 340 as the "Option 2" formula for Safety members.

For new members, we have calculated the applicable member contribution rate for each new plan. This is a single rate payable by all new entrant members of the plan. The law is not explicit about whether all new entrant members must pay a single rate based on plan only, or if member contribution rates may vary by entry age and plan as they do for current members; however, it seems to imply that the single rate would apply. Our understanding is that SBCERS staff intends to recommend the use of a single member contribution rate for each PEPR plan. We agree with this approach.

Note that there may be cases where the existing Memorandum of Understanding (MOU) may take precedence in the determination of an individual member's contribution rate. Please see the section in this letter titled Potential Adjustment to Employer Contribution Rates for consideration on how to apply the employer contribution rates due in these cases, as well as special adjustments to consider in the payment on the Unfunded Actuarial Accrued Liability (UAAL) contribution rates.

We have used the same UAAL contribution rates as are currently being used for all current SBCERS plans, effective July 1, 2012 through June 30, 2013. The UAAL contribution rates adopted based on our June 30, 2012 valuation should be implemented for new entrants effective with the July 1, 2013.

Note that for Safety members, we have used the UAAL Contribution rate based on the UAAL contribution rate for Safety Plan 4 members. There is a separate amortization for the UAAL attributable to the creation of Safety Plan 6. Currently, that liability is being amortized over a closed period based on a level percentage of Safety Plan 6 payroll, which is assumed to increase by 3.75% each year. Now that Safety Plan 6 is closed to new entrants, the methodology for amortizing the Safety Plan 6 UAAL should be reviewed.

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The change in pensionable compensation under the provisions of PEPRA will have some impact on the expected future payroll that the UAAL contribution rates are based. In the short term, we expect the impact to be relatively small, but we recommend an adjustment to UAAL rates be considered to maintain the current level of funding. Please see the section in this letter titled Potential Adjustment to Employer Contribution Rates for this discussion.

Member Contribution Rates

For new members, we have calculated the applicable member contribution rate for each new plan equal to one half of the total normal cost rate as specified in the Section 7522.30(c) of the legislation. Note that we have rounded the member rate to the "nearest quarter of 1 percent" as also required by the legislation. In some cases this results in a member rate being less than one-half of the normal cost rate. The calculated values are single rates (shown previously in contribution rate chart) payable by all new entrant members of the respective plan. The legislation is not clear if all new entrant members must pay a single rate, or if member contribution rates may vary by entry age as they do for current members. As previously noted, we agree with the SBCERS staff recommendation to use a single member contribution rate for each PEPRA plan.

If necessary, we can provide alternative member rates that vary by entry age. Those rates could also be rounded to the nearest one-quarter of a percent and would be set such that the total member contribution rates would be expected to be one half of the total normal cost rate.

Note that there may be cases where the existing MOU will take precedence in the determination of an individual member's contribution rate.

Impact of Legislation on Current Members

There are a number of provisions in AB340 that apply to existing members. These include limitations on members returning to work after retirement, the prohibition of nonqualified service purchases, and the prohibition of retroactive benefit increases, among others. Although these changes could ultimately affect SBCERS's costs, there are no assumptions for these events in the valuation, so there will be no impact on the current valuation based on the assumptions used in our analysis. Our understanding is that there are three potential changes to current members that could impact the valuation. At this time, we are not recommending any changes to the valuation.

1. Government Code 7522.66 includes enhanced service-connected disability benefits for Safety members who become disabled between January 1, 2013 and December 31, 2017. It is not clear if this enhancement applies to '37 Act systems. We have included the value of these benefits in both our June 30, 2012 actuarial valuation and this study.
2. Employers may require current members to pay half of the normal cost effective January 1, 2018. Since it is not known whether this will occur, we have assumed there will be no change in current member contribution rates for purposes of this analysis.
3. The definition of "compensation earnable" is restricted to limit additional payments over what would normally be paid over each 12-month period. Our understanding is that this is not expected to affect current member pensionable compensation for SBCERS.

Description of Plans

Under PEPR, the open SBCERS plans (General Plans 5B, 5C & 7, APCD Plan 2, and Safety Plans 4B, 4C & 6B) will be closed to new members. New plans will need to be established either based on the PEPR formula or, alternatively, the current SBCERS formula (with some required PEPR revisions) if the normal cost is lower. We demonstrate below that the current SBCERS formulas do not appear to be permissible. Note that an annual CPI COLA up to 2% is included for General members and a 3% annual COLA for Safety members per your request.

With the exception of the additional temporary duty disability benefits mentioned above, we assume that the new plans will have no impact on the death and disability provisions. We also assume that there will be no change to the ability to use sick leave for service credit for retirement benefits.

Description of AB340 Provisions Applicable to New Members (PEPR)

The following changes in plan provisions would be required by PEPR:

Changes Applying for All New Plans (New Entrants Only)

- The member contribution rate is set equal to one-half the normal cost rate. It is not clear to us from the legislative language whether the current practice of varying member contribution rates by entry age would continue or if each member in the new plan would contribute at the same rate.
- Pensionable compensation is restricted to base pay, reducing the pay elements to be used in the calculation of benefits for new members. Our understanding is that this will result in a small reduction in the pensionable compensation, as compared to the pensionable pay for similar current members. We have not made any adjustments for this in our analysis. This issue should be reviewed with the next investigation of experience.
- Compensation for purposes of determining retirement benefit amounts is limited to 100% (120% for APCD and Safety members) of the Social Security Taxable Wage Base (SSTWB) in 2013. Note that 120% applies to APCD and Safety members as it is our understanding that these SBCERS members are not covered by Social Security. This limit is subject to annual indexing based on changes in the Consumer Price Index for All Urban Consumers.
- No benefits in excess of the Internal Revenue Code (IRC) Section 415 limits would be paid. Currently, these benefits may be paid via a replacement benefit plan. Note that the 100%/120% of SSTWB compensation limit makes it unlikely that new entrants will be subject to the 415 limit. For purposes of this analysis, we have assumed there is no cost or savings due to these provisions.
- PEPR requires that the calculation of final compensation be averaged over a consecutive 36-month period for all new members.
- Additional provisions apply to retroactive benefits, retired members who return to work, service purchases, pension contribution holidays, and public officials convicted of a felony. For purposes of this analysis, we have assumed there is no cost or savings due to these provisions.

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Changes for the New General Plan (New Entrants Only)

- The earliest eligibility for retirement is at age 52 with 5 years of service. Currently, General members are eligible for service retirement with 30 years of service or age 50 with 10 years of membership.
- New retirement age factors replace the current formula factors. The PEPRA factors are lower than the current Plan 7 factors at all ages less than age 66.50. For other plans currently open to new members (Plan 5 and APCD), the new factors will be lower at all ages.

Changes for the New Safety Plan (New Entrants Only)

- The earliest eligibility for retirement is at age 50 with 5 years of service. Currently, Safety members are eligible for service retirement with 20 years of service or age 50 with 10 years of membership.
- New retirement age factors replace the current formula factors. These factors are lower than the current factors at all ages. A comparison is shown following this section.
- **Safety Disability Benefit:** We have included the enhanced Safety disability benefit discussed in the section on current members per your request.

Revised Age Factors

As mentioned above, the legislation will result in a revised set of age factors for new members who enter the system after January 1, 2013 for the SBCERS plans. The following chart shows a comparison of the new age factors with the age factors in place under the current plans.

Comparison of Formula Percentages (General)							
Retirement at Age	PEPRA	General Plan 5		General Plan 7		APCD Plan 2	
		Percent	vs PEPRA	Percent	vs PEPRA	Percent	vs PEPRA
52	1.00%	1.49%	Higher	1.30%	Higher	1.67%	Higher
53	1.10%	1.58%	Higher	1.36%	Higher	1.77%	Higher
54	1.20%	1.67%	Higher	1.43%	Higher	1.88%	Higher
55	1.30%	1.77%	Higher	1.49%	Higher	2.00%	Higher
56	1.40%	1.88%	Higher	1.56%	Higher	2.09%	Higher
57	1.50%	2.00%	Higher	1.64%	Higher	2.21%	Higher
58	1.60%	2.09%	Higher	1.73%	Higher	2.34%	Higher
59	1.70%	2.21%	Higher	1.82%	Higher	2.47%	Higher
60	1.80%	2.34%	Higher	1.92%	Higher	2.62%	Higher
61	1.90%	2.47%	Higher	1.99%	Higher	2.72%	Higher
62	2.00%	2.62%	Higher	2.09%	Higher	2.82%	Higher
63	2.10%	2.62%	Higher	2.20%	Higher	2.93%	Higher
64	2.20%	2.62%	Higher	2.31%	Higher	3.03%	Higher
65	2.30%	2.62%	Higher	2.43%	Higher	3.13%	Higher
66	2.40%	2.62%	Higher	2.43%	Higher	3.13%	Higher
67	2.50%	2.62%	Higher	2.43%	Lower	3.13%	Higher

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For Safety plans, the legislation provides for three separate benefit formulas – a base formula and two options. We have used Option 2 for new Safety members as it has the percentage factor that is closest to and provides a lower benefit factor at age 55, consistent with the guidance in the legislation.

Comparison of Formula Percentages (Safety)					
Retirement at Age	PEPRA Option 2	Safety Plan 4		Safety Plan 6	
		Percent	Compare	Percent	Compare
50	2.00%	2.29%	Higher	3.00%	Higher
51	2.10%	2.41%	Higher	3.00%	Higher
52	2.20%	2.54%	Higher	3.00%	Higher
53	2.30%	2.68%	Higher	3.00%	Higher
54	2.40%	2.83%	Higher	3.00%	Higher
55	2.50%	3.00%	Higher	3.00%	Higher
56	2.60%	3.00%	Higher	3.00%	Higher
57	2.70%	3.00%	Higher	3.00%	Higher

Comparison of Current Formulas with PEPRA Formulas

Under Section 7522.02(d) of the legislation, a public employer may continue to offer their current plan formula, without a compensation cap, as described later, if the following criteria hold:

1. The employer's current benefit formula has a lower benefit factor at normal retirement age than the PEPRA benefit formula, and;
2. It is determined that the current formula with certain revisions required by PEPRA has a "lower normal cost" than the PEPRA benefit formula.

Note that under criterion 1 above, a comparison is performed at the normal retirement age; however, PEPRA does not specify a normal retirement age. For purposes of this analysis, we have interpreted the normal retirement age to be equal to the age under the current formula where the benefit factor first reaches the maximum amount.

- General Plan 5 = Age 62
- General Plan 7 = Age 65
- APCD = Age 65
- Safety Plan 4 = Age 55
- Safety Plan 6 = Age 50

We have concluded that all of the current open plan formulas fail the lower formula test, because the current formulas have a higher benefit factor at the normal retirement age. It should also be noted that none of the current plans satisfy the second test either, as they all have a higher normal cost. Therefore, we have concluded that only the General and Safety PEPRA formulas may be offered to new entrants.

Potential Adjustment to Employer Contribution Rates

In the Summary Results section, we show the recommended employer contribution rates. It should be noted that these are theoretical contribution rates assuming that all new members pay the recommended member rate immediately and that future pensionable payroll increases 3.75% per year. Given certain provisions of PEPRA as detailed below, we expect the actual contributions will fall short of the calculated actuarial rate even if all assumptions are met in the future. These shortfalls are expected to be small, but we recommend the Board consider approaches to address this difference.

- **Member Rates:** The recommended Employer Normal Cost rate assumes that the calculated member rate is paid by all members. However, as previously noted, new members covered by an existing MOU may pay a different rate. To the extent this differs from the calculated member rate, the total contribution received by SBCERS for the individual will be less than (or greater than) the actuarially calculated rate. One option would be to collect/credit the difference between the actual and calculated member contribution rates to the employer contribution if these situations occur.
- **UAAL Contributions:** Pensionable payroll will be reduced to the extent individual members' compensation exceeds the PEPRA SSTWB-based limit. Additionally, the new definition of pensionable compensation is more restrictive than the current definition in terms of which compensation elements will be included. These changes are expected to reduce the total pensionable payroll. If employer contributions to pay off the UAAL are based on this more restrictive pensionable compensation, the contributions received will be less than under the current plans, since the UAAL contribution rates are the same and pensionable compensation is less.

These shortfalls are not expected to be material in the short term, as there will only be small portion of the active population subject to the PEPRA restrictions; therefore, we believe the recommended UAAL contribution rates are still appropriate. However, the impact of PEPRA on payroll will increase in the future as more new entrants are covered by PEPRA. Accordingly, the impact of PEPRA on the payroll assumption should be reviewed with the next investigation of experience. If it is desired to fully make up for this minor shortfall prior to the time of the investigation of experience, an adjustment could be made to the UAAL rate for new members, but we are not recommending that at this time.

Sensitivity to Assumptions

The assumptions used have a material impact on the anticipated cost of the benefits. We have used the same data, methods, and assumptions as those used in our June 30, 2012 actuarial valuation for SBCERS, except where noted, in our calculation of the recommended contribution rates under PEPRA. Note that for Safety members we have used the same assumptions as those used for current Plan 4 members.

The following are some of the key assumptions that were made in this analysis and our comments on their potential impact:

- **Investment Return:** The cost analysis assumes that SBCERS's current and future assets earn 7.75%. If the actual returns in the future are greater, this would reduce the ultimate normal cost rate for PEPRA benefits. Conversely, if actual returns are less than 7.75%, it would increase the ultimate cost of PEPRA benefits. For example, we previously recommended the investment return assumption be reduced to 7.50% or lower. If this decrease is adopted in the future, this will result in an increase in the total normal cost rate, and possibly the member rate.
- **Rates of Retirement:** The age at which members retire can have a material impact on costs. Due to the new legislation, the retirement behavior of future SBCERS members would likely change. In particular, the change in retirement eligibility and the new percentage factors would likely impact members' retirement choices. Note that we have adjusted the retirement rates for General members under PEPRA, as discussed in the Modified Assumptions section.
- **Entry Age of Population:** Our analysis assumes the makeup of the new entrant group is consistent with the recent new entrant population, as described in the New Entrant Population section. The normal cost rate for each individual is influenced by his or her entry age. Members with older entry ages tend to have higher normal cost rates than members with younger entry ages. Therefore, the total normal cost rate for members who enter in 2013 or later will vary from our estimate to the extent that the actual entry ages vary from those of the new entrant population used in our analysis.

New Entrant Population

The actual costs of the new plans will vary depending on the makeup of the new entrant population. It is unknown exactly what the future SBCERS population will look like, but we have a good proxy in the current active population. In determining the normal cost rate for new members, we have used the current active member population with hire date after June 2007. Only recent hires were included in the analysis as we believe it provides a better estimate of the future new entrant population. We combined the new hires from APCD with the General members for purposes of this estimate. The following shows a comparison of the average entry age for all current members (Valuation) and just for those hired within the last five years (PEPRA).

Group	Average Entry Age	
	Valuation	PEPRA
General and APCD	34.8	36.5
Safety	30.1	33.4

Recent hires have tended to have higher entry ages than the full SBCERS active population. As previously noted, members who enter at older ages tend to have higher normal cost rates. As discussed earlier, we believe the recent new entrant population is the best predictor of future new entrants, so we feel this is the best approach for setting contribution rates for future members.

Modified Assumptions

We used the June 30, 2012 valuation assumptions as the basis for this analysis. However, there were two situations where we felt the change to the PEPRA formula was significant enough to merit revised assumptions:

1. **Rates of Retirement:** Due to the lower benefit factors, we expect General members to retire later under PEPRA. We have proposed lower retirement rates for General members that we have used in this analysis. They are shown in Exhibit 1. We have used the current Safety Plan 4 retirement rates for new Safety members.
2. **Entry Age of Population:** Currently, there is no termination assumed after 20 years of service for Safety members, as active Safety members are eligible for service retirement at those service levels. Under the new PEPRA formulas, it is our understanding that these members would no longer be automatically eligible for service retirement at the 20-year threshold. Therefore, we believe it is more likely that a Safety member may terminate, while not being eligible to retire, at these service levels. We have proposed new termination assumptions of 0.6% per year for Safety members with service greater than or equal to 20 years. We have used our actuarial judgment to propose these rates based on our experience working with SBCERS and other large retirement systems.

Actuarial Certification

All data, methods, and assumptions are the same as those used in our June 30, 2012 actuarial valuation for SBCERS, except where noted. It should be noted that member behavior may change as a result of plan changes. We have not anticipated any changes in member behavior in the assumptions used in our analysis (except where noted).

The cost estimates presented in this letter reflect changes in the benefits provided to SBCERS members, as described in this letter and in Assembly Bill 340. These cost estimates are subject to the uncertainties of a regular actuarial valuation; the costs are inexact because they are based on assumptions that are themselves necessarily inexact, even though we consider them reasonable.

The consultants who worked on this assignment are pension actuaries. Milliman's advice is not intended to be a substitute for qualified legal or accounting counsel. These possible changes should be reviewed by counsel. Note that we have not explored these or any other legal issues with respect to the proposed plan changes.

In preparing the valuation upon which this letter was based, we relied without audit, on information (some oral and some in writing) supplied by SBCERS staff. This information includes, but is not limited to, statutory provisions, employee data and financial information. In our examination of these data, we have found them to be reasonably consistent and comparable with data used for other purposes. It should be noted that if any data or other information is materially inaccurate or incomplete, our calculations may need to be revised.

All costs, liabilities, rates of interest, and other factors for SBCERS have been determined on the basis of actuarial assumptions and methods which are individually reasonable (taking into

account the experience of SBCERS and reasonable expectations); and which, in combination, offer a reasonable estimate of anticipated experience affecting SBCERS.

Future actuarial measurements may differ significantly from the current measurements presented in this report due to such factors as the following: plan experience differing from that anticipated by the economic or demographic assumptions; changes in economic or demographic assumptions; increases or decreases expected as part of the natural operation of the methodology used for these measurements (such as the end of an amortization period or additional cost or contribution requirements based on the plan's funded status); and changes in plan provisions or applicable law. Due to the limited scope of our assignment, we did not perform an analysis of the potential range of future measurements. The Board of Retirement has the final decision regarding the appropriateness of the assumptions and adopted as shown in Appendix B of the June 30, 2012 actuarial valuation report.

Actuarial computations presented in this letter are for purposes of determining the member and employer contribution rates for new members. The calculations in this letter have been made on a basis consistent with our understanding of SBCERS current funding requirements. Determinations for purposes other than meeting these requirements may be significantly different from the results contained in this letter. Accordingly, additional determinations may be needed for other purposes.

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On the basis of the foregoing, we hereby certify that, to the best of our knowledge and belief, this cost study letter is complete and accurate and has been prepared in accordance with generally recognized and accepted actuarial principles and practices. We are members of the American Academy of Actuaries and meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained herein.



We respectfully submit this analysis and we look forward to discussing it with you.

If you have any questions, please contact us.

Sincerely,

A handwritten signature in black ink, appearing to read 'Nick Collier'.

Nick J. Collier, ASA, EA, MAAA
Consulting Actuary
NJC/DRW/nlo

Enclosure

cc: Mr. Gary Amelio
Ms. Lila Deeds

A handwritten signature in black ink, appearing to read 'Daniel Wade'.

Daniel R. Wade, FSA, EA, MAAA
Consulting Actuary

Exhibit 1

Rate of Service Retirement from Active Service For General Members

Age	PEPRA Study		June 30, 2012 Valuation	
	Male	Female	Male	Female
50	N/A	N/A	3.0%	7.0%
51	N/A	N/A	4.0%	3.0%
52	2.4%	1.8%	4.0%	3.0%
53	2.4%	1.8%	4.0%	3.0%
54	2.4%	5.4%	4.0%	9.0%
55	2.4%	5.4%	4.0%	9.0%
56	3.6%	5.4%	6.0%	9.0%
57	3.6%	5.4%	6.0%	9.0%
58	3.6%	5.4%	6.0%	9.0%
59	7.2%	7.2%	12.0%	12.0%
60	9.0%	9.0%	15.0%	15.0%
61	15.0%	10.8%	25.0%	18.0%
62	20.0%	20.0%	25.0%	25.0%
63	20.0%	20.0%	25.0%	25.0%
64	20.0%	20.0%	25.0%	25.0%
65	25.0%	25.0%	25.0%	25.0%
66	25.0%	25.0%	25.0%	25.0%
67	40.0%	40.0%	25.0%	25.0%
68	25.0%	25.0%	25.0%	25.0%
69	25.0%	25.0%	25.0%	25.0%
70	25.0%	25.0%	25.0%	25.0%
71	25.0%	25.0%	25.0%	25.0%
72	25.0%	25.0%	25.0%	25.0%
73	25.0%	25.0%	25.0%	25.0%
74	25.0%	25.0%	25.0%	25.0%
75	100.0%	100.0%	100.0%	100.0%

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