Response to Questions on the FY 2016 Budget

Request By: Supervisor Cook

Question: Please provide an update on recent changes to pension funding.

Response: The County currently uses a corridor approach to employer contributions for the three pension systems, the Employees' Retirement System (ERS), the Uniformed Retirement System (URS), and the Police Officers Retirement System (PORS). The corridor approach was adopted by the Board of Supervisors in FY 2002 at a time when the funding ratios for the three retirement systems ranged from 97 to 102 percent. It was designed by the County's actuaries to set annual contributions at the level necessary to maintain strong funding ratios in each of the plans while reducing the volatility in the employer contribution rates that is typical for plans that are near fully-funded. In the corridor method of funding, a fixed contribution rate is assigned to each system and the County contributes at the fixed rate unless the system's funding ratio falls outside the pre-selected corridor of 90-120 percent or if benefit enhancements are approved. If the funding ratio falls below 90 percent, the unfunded actuarial accrued liability below 90 percent is amortized over a conservative 15-year period, and this amount is included in the annual employer contribution for each fund.

The corridor approach cushioned the County from dramatic rate increases while maintaining strong funding ratios for several years. However, the global financial crisis during FY 2009 resulted in significant losses in the value of the invested assets of all three retirement systems. By the end of FY 2010, funding ratios had fallen to between 72 and 82 percent. Because only 90 percent of the unfunded liability is amortized and included in the employer contribution under the corridor approach, the funding ratios have improved since then, but at a slower pace than desired. As a result, the County has taken multiple steps to improve the financial position of the retirement systems. These steps include increasing contribution levels and limiting increases in liabilities:

- In FY 2010, the requirements regarding the award of ad-hoc Cost-of-Living Adjustments (COLAs) were tightened, requiring that the retirement system must have an actuarial surplus, demonstrated by having a funding ratio exceeding 100 percent, before an ad-hoc COLA can be considered.

- In FY 2011, the employer contribution rates were increased by adjusting the amortization level of the unfunded liability from 90 percent to 91 percent.

- In FY 2012, the Department of Human Resources, as directed by the Board of Supervisors, contracted with a benefits consultant to conduct a comprehensive review of the retirement plans. Based on the results of this study, the Board of Supervisors adopted several modifications to the retirement systems, which apply only to new employees who are hired on or after January 1, 2013. These changes include increasing the minimum retirement age for normal service retirement from 50 to 55 in the Employees' system; increasing the rule of 80 (age plus years of service) to the rule of 85 in the Employees' system; placing a cap on the use of sick leave for purposes of determining retirement eligibility and benefits at 2,080 hours for all three retirement systems; and, for the Deferred Retirement Option

Plan (DROP), removing the pre-Social Security supplement from balances accumulated during the DROP period in the Employees' and Uniformed systems.

- In FY 2015, the employer contribution rates were increased by adjusting the amortization level of the unfunded liability from 91 percent to 93 percent.

These actions, combined with recent strong investment returns, have improved the funding ratios of the systems to between 78 and 87 percent, and the funding ratios would continue to improve under the current funding policy provided that investment returns continue to meet or exceed the long-term target of 7.5 percent. However, the County is now under pressure to significantly increase its pension funding policies as a result of feedback from the bond rating agencies as well as changes in Governmental Accounting Standards Board (GASB) policies.

The bond rating agencies, with Moody's in particular, have recently expressed concern that the County's pension systems are not adequately funded. As a result of this and other factors, the County's AAA bond rating is currently being reviewed. The AAA rating is critical for debt service affordability and access to funds in support of critical capital projects. The County has maintained the AAA rating since 1978, and it has saved the County $662 million since that time.

A second factor necessitating an increase in pension funding is changes to pension reporting mandated under GASB Statements 67 and 68, which require that the full amount of the County's unfunded pension liability be reported on the balance sheet in the Comprehensive Annual Financial Report (CAFR). The unfunded liability is currently calculated using a discount rate of 7.5 percent based on the long-term expectation of the systems' investment earnings. However, under GASB 67 and 68, a lower discount rate must be used unless the systems each pass an asset depletion test. Funding to the pension systems must be increased in order to pass this asset depletion test. If funding is not increased, the unfunded pension liability reported on the County's balance sheet will be significantly higher – by over $1 billion under initial projections – as a result of the requirement to use a lower discount rate.

In order to alleviate the concerns of the rating agencies while also meeting the requirements under GASB 67 and 68 to continue to use a discount rate of 7.5 percent, the Board expressed the County's commitment to increasing its pension funding in a letter to Moody's dated January 14, 2015. This commitment includes increasing the amortization level of the unfunded liability from 93 percent to 100 percent by the end of the decade, resulting in 100 percent funding of the Annual Required Contribution (ARC), as well as a goal of reaching a 90 percent funded status for all plans by 2025. In order to fulfill this commitment, the <u>FY 2016 Advertised Budget Plan</u> includes the following multi-year strategy:

- In FY 2016, the employer contribution rates will be increased to adjust the amortization level of the unfunded liability from 93 percent to 95 percent.

- Increases in the employer contribution rates will continue so that the County will amortize 100 percent of the unfunded liability by FY 2020 at the latest, fully funding the Annual Required Contribution for all systems. The County will continue to use a conservative 15-year amortization period.

- Until each system reaches 100 percent funded status, employer contributions to that system will not be reduced. Various factors, such as the historical trend of the County's investment returns exceeding the assumed rate of 7.5 percent, could allow employer contribution rates to be reduced from current levels. However, the County is committed to maintaining the rates and redirecting any potential savings into further improvement in the systems' funded positions.

- Any additional unfunded liability created as a result of approved benefit enhancements, such as ad-hoc COLAs, will be fully funded. It is the intent that no adjustments to benefit levels will reduce the funded status of any of the systems.

The first bullet under this strategy, adjusting the amortization level of the unfunded liability from 93 percent to 95 percent, has been included in the FY 2016 Advertised Budget Plan. This action results in an increase of $10.2 million in General Fund employer contributions to the three retirement systems over the FY 2015 level. It should be noted that the net General Fund impact of changes to the employer contribution rates to the pension systems, including this change in the amortization level as well as changes resulting from the annual actuarial valuation of the systems, is $8.6 million. This lower net impact reflects the strong investment earnings that have been realized in the retirement systems.