SWEETWATER SPRINGS WATER DISTRICT

TO: Board of Directors **AGENDA NO. V-G**

FROM: Steve Mack, General Manager

Meeting Date: May 1, 2014

SUBJECT: PERS Unfunded Liability

RECOMMENDED ACTION:

Develop a set of questions for our PERS Actuary, Barbara Ware.

FISCAL IMPACT:

(None.)

DISCUSSION:

At the March meeting, the Board had questions regarding our unfunded liability with CalPERS and how it relates to the lump sum payoff the District made several years ago. Staff has contacted Barbara Ware, our actuary at CalPERS. After this Board meeting we will meet with her via telephone to answer to any questions we might have about PERS unfunded liability.

The discussion below reviews our current PERS premiums, then discusses the how key events impacted our rates since we joined PERS in 2001. Since the discussion involves use of PERS retirement terms, attached is a glossary provided in our most recent Annual Valuation Report which staff has found very useful in trying to understand the technical aspects of our retirement rates. Terms in the glossary are **bolded** when they are first used in the discussion.

Part 1. Current Annual Retirement Premiums

PERS breaks down annual retirement premiums into Employee Share and Employer Share. The District currently pays both. Annual premium charges are expressed as a percentage of payroll. The Employee Share is always a fixed 7% of payroll - it is not the focus of this discussion. Our Employer Share, on the other hand, changes every year. Currently it has three parts: **normal cost, unfunded liability, and side fund liability**. In FY 2014-15, our normal cost rate is 7.824%, our unfunded liability rate is 3.208%, and our side fund rate is 0.0% of payroll, for a total Employer Rate of 11.032%, plus the Employee Rate of 7%.

Ideally, all benefits could be funded from the normal cost. However, when benefits are increased retroactively (as they were when we joined and again when moved to a better

plan),or there are **actuarial losses**[1] or PERS changes either their **actuarial assumptions or the actuarial methods** , the cost to recover/catch-up shows up as an unfunded liability.

So how has the Employer Share changed for the District over the years?

Part 2. History

The District joins PERS. The District joined the PERS 2% at 60 Plan in 2001, using the existing employee retirement account as an initial payment to PERS. The prior retirement account covered only a small fraction (our **funded ratio** was just over 20%[2]) of the costs to join PERS and provide employees with PERS benefits retroactive to their hire date. PERS charged 8.25% interest on the difference, and broke out the portion of our rates that would pay this **unfunded liability**. In our first Annual Valuation Report prepared as of June 30, 2002, the employer share broke down as follows for FY 2004-05:

Normal cost: 6.880%
Unfunded liability: 8.221%
Total Employer share: 15.101%

In 2004, mindful of the high interest rate being charged on our unfunded liability, the District chose to make a **lump sum payment** of $427,885 that eliminated most of this liability.

PERS implements risk pools. Beginning with the 2005-06 year, PERS required the District (and all small agencies) to be part of a risk pool rather than evaluated on our own demographics and payroll, in the hopes of reducing large fluctuations in contribution rates. Our risk pool consisted of all employers in the 2% at 60 plan. The risk pool had its own unfunded liability, but at the time we joined a **side fund** was established for us that accounted for the difference between our unfunded liability level versus the pool's. Staff views the side fund as a post-risk pool subset of unfunded liability that is agency-specific.

It should be noted here that staff also believes the side fund is a static number, subject to interest but not to fluctuations arising on differences between actuarial assumptions and reality and/or changes to actuarial assumptions and methods[3].

Our employer share after becoming part of the risk pool (and after the first lump sum payment) broke down as follows for FY 2006-07:

Normal cost: 6.479%
Unfunded liability of the 2% at 60 pool: 0.089%

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[1] Actuarial losses (or gains) are an important and ever-changing component of unfunded liability. Consider the effect on unfunded liability when retirees live longer than the actuarial assumption (demographic loss), or market losses like the dot.com bust or the 2008 recession wreak havoc on the actuarial assumption of market return (economic loss). Staff has concluded most times the word "actuarial" is used it means PERS has used assumptions -- either demographic or economic -- that reality will either prove too conservative or too liberal. If too liberal "actuarial losses" result.

[2] As of June 30, 2012, our funded ratio was 91.2% using an **actuarial valuation of assets (AVA basis)**. Using a **market value of our assets (MVA)**, 77.2%. Staff has looked at the District's (later, the pool's) funded ratio over time. On an MVA basis, on June 30, 2004 96.1%; June 30, 2007 110.5%; June 30, 2009 64.9%; June 30, 2012 77.2%.

[3] PERS changes its mind about what actuarial assumptions should be and what methods to use about every two years. As an example, when the District joined PERS in 2001, actuarial assumptions included an investment return of 8.25%, and the **actuarial methodology** contemplated a 3-year smoothing technique for differences between assumptions and reality. Today, PERS assumes a 7.5% investment return and uses a 30-year smoothing technique. Each change impacts unfunded liability , either as an actuarial gain or an actuarial loss. Since the District has joined PERS 13 years ago, staff believes there have been more actuarial losses than gains.

Side fund: .916%
Total Employer share: 7.484%[4]

The District upgrades from the 2% at 60 to the 2% at 55 Plan and makes a lump sum payment to pay off the Side Fund. In 2011 District negotiations with employees resulted in a retroctive retirement upgrade to the 2% at 55 plan. Our move to the new risk pool was accompanied by a recalculation of our side fund based on the retroactivity cost of the enhanced benefit. The District made a second lump sum payment in the sum of $230,511 in June 2011 and paid off the entire side fund. Because the side fund is a static figure, staff believes that once paid off it will remain paid off unless the District chooses to enhance retirement benefits retroactively again sometime in the future.

So why do our rates keep going up?

Staff has taken a closer look at the breakdown of our employer rates since joining the 2% @ 55 pool. It appears that the majority of the increase is due to the pool's unfunded liability, not the normal cost, as shown in the table below:

Year	Normal Cost Rate	Unfunded Liability Rate	Side Fund Rate	Total Employer Rate (% of payroll)
FY 2011-12	6.622%	1.11%	0.0%	7.73%
FY 2012-13	7.72%	1.99%	0.0%	9.71%
FY 2013-14	8.052%	2.23%	0.0%	10.28%
FY 2014-15 (est.)	7.824%	3.208%	0.0%	11.03%

The table shows that the unfunded liability rate has almost tripled from FY 2011-12 to FY 2014-15. This reasons for this increase is a question staff has for our actuary. Other questions:

What impact, if any, does the District's own demographics and payroll have on the employer rates we pay?
Do we have our own funded ratio, or just the pool's?
Which funded ratio do we read about in the newspapers - AVA or MVA?
How does the current smoothing methodology actually work?
What factors impact the normal cost rate?

What does the future hold?

Undoubtedly, change.

PERS is considering more changes to the actuarial assumptions and methodology, in part due to the impact of **PEPRA**. To gain a better understanding of proposed changes staff will participate in a webinar next week put on by CSDA titled "Proposed Changes to Risk Pooling." CSDA hasn't put out a brochure for the webinar, but attached is background information for your review. Staff is wondering how much impact this new round of changes will have on our rates.

What questions does the Board have?

[4] Net of the Phase out of Normal Cost Difference, which won't be discussed in this staff report.