



MEMORANDUM

DATE: November 29, 2007

TO: David Bracilano, Director of Labor Relations

FROM: Dwight Dively, Director of Finance

RE: Request for Retirement System Information from Local 17

Thanks for forwarding Local 17's questions about the Seattle City Employees Retirement System (SCERS). I have copied their questions below and have provided answers to each. Please let me know if you or Local 17 have additional questions. Thanks.

- 1. What laws govern the Retirement Fund?** SCERS was created in 1929 through Ordinance 57075. The System is authorized by Article XXII, Section 13 of the City Charter. Chapter 4.36 of the Seattle Municipal Code governs the operation of the System. It is important to recognize that there is a large body of case law in Washington State that also affects the System.
- 2. What is the definition of unfunded liability?** Unfunded liability is a term used by actuaries to describe a benefits program that does not have sufficient existing assets to cover promised future benefits. For a retirement system, an actuary calculates the amounts expected to be owed to current retirees and current employees who will eventually retire. These represent the liabilities of the system. The actuary then examines existing financial assets (e.g., the more than \$2 billion currently held by SCERS) plus expected payments from current employees and the employer. These represent the assets of the system. The actuary then converts all of these figures to present values (the value today) to see if the system is "fully funded." A fully funded system has enough current and future assets to pay all projected liabilities. If the system is not fully funded, the "gap" between assets and liabilities is called the "unfunded liability."
- 3. What does 30-year unfunded liability mean?** An unfunded liability is sometimes expressed as the number of years it would take at current contribution rates (employer plus employee) to eliminate the unfunded liability. Thus, a 30-year unfunded liability means it is projected to take 30 years at current contribution rates for a system to become fully funded. This was the situation for SCERS in the early 1990s.

Actuaries also use the term “funding ratio” to reflect the financial health of a system. This is the ratio of the value of assets to the value of liabilities. So, a 90% funding ratio means the system has 90% of the assets needed to cover expected liabilities.

- 4. What is the current funding ratio and how does that transfer to years of unfunded liability?** Milliman Consultants serves as the actuary for SCERS. On July 31, 2007, Milliman provided an actuarial valuation of SCERS as of April 30, 2007. The funding ratio at that time was calculated to be 97.3%. Because this was over 95%, improvements in benefits were triggered as of December 2007, including extending the annual 1.5% cost-of-living adjustment (COLA) to all retirees and raising the “floor” from 60% to 65%. The floor limits the decline in purchasing power of the retirement benefit. Starting in December, retirees will be assured that the “real” value of their benefit, after accounting for inflation, will never be less than 65% of the value when they retired. Because there are costs associated with these benefit improvements, the funding ratio as of April 30 was estimated to be 95.3% once the benefit enhancements were recognized.

Milliman did not calculate the unfunded liability in years, but based on prior analyses, the 95.3% funding ratio would translate into four to seven years.

SCERS has had strong investment performance after April 30, so the current funding ratio is likely to be slightly higher than 95.3%.

- 5. How much of a contribution percentage increase would result for every year the fund went beyond a 30 year unfunded liability (e.g. if the fund was at a 32 year unfunded liability, how much of a percentage in contribution would need to be raised)?** The answer to this question requires two preliminary pieces of information. First, current contribution rates to SCERS (8.03% for both employees and the employer) are more than needed to cover “normal costs.” Normal costs are calculated by the actuary to represent the cost of future benefits for current employees. Milliman’s July 2007 report calculated that a contribution rate of 12.87% would be needed to cover normal costs. Thus, the City and current employees are paying a combined 3.19% of salary (16.06% minus 12.87%) to reduce the current unfunded liability.

Second, the Governmental Accounting Standards Board (GASB) sets guidelines for acceptable periods of unfunded liabilities. A 40-year unfunded liability was considered acceptable for many years. Two years ago, GASB determined that the maximum acceptable unfunded liability should be 30 years. GASB’s pronouncements do not have the force of law and thus are not mandatory. However, compliance with the standards is generally expected by auditors and bond rating agencies.

If a system falls below the 30-year standard, no immediate action would be required. However, if no action is taken and the system remains below the 30-year standard for several years, auditors and rating agencies would likely insist on either reductions to benefits (which are not allowed for existing members under Washington law) or higher contribution rates.

It is not possible to provide a specific answer to the question about a 32-year unfunded liability. The answer would depend on the assets, liabilities, and expected investment performance of the system at that time. It is safe to say that any required increase to address a 32-year unfunded liability would be small – certainly less than a 1% increase in the total 16.06% rate.

6. What are the benefits and detriments of allowing up to a 30 year unfunded liability?

Good financial practices support having a fully funded system. Once a system reaches full funding, benefits can be increased and/or contributions can be reduced (it is typically desirable to maintain some funding cushion to offset potential investment shortfalls, so a funding ratio of somewhat more than 100% would be ideal). Systems typically have unfunded liabilities when they are started because benefits are often extended to some individuals (typically older workers) at levels beyond what their own contributions would justify.

Some retirement systems have accumulated large unfunded liabilities due to poor management, unwillingness to make adequate contributions, and/or excessive benefits. In the public sector, the recent travails of the City of San Diego are a case in point. Dealing with a large funding shortfall has necessitated significant job cuts and wage freezes. Similar patterns can be seen in some private sector firms, including airlines and automakers.

7. What are the benefits and detriments of the fund going beyond a 30 year unfunded liability? See previous answers. As a practical matter, the City could not allow SCERS to have a greater than 30-year unfunded liability for a long period of time.

8. What events or factors could contribute to raising a level of unfunded liability? The actuarial health of a retirement system depends on a complicated array of factors. The most obvious factor that would increase the unfunded liability would be a significant and prolonged decline in investment performance. Benefit increases or contribution reductions would also increase the unfunded liability. Finally, very high inflation could increase the unfunded liability unless it was accompanied by a similar high level of investment returns.

9. What is the City's investment philosophy and strategy? It is important to recognize that the City does not run SCERS and does not set its investment strategy. SCERS is managed by a seven-person Board consisting of three City officials (the Chair of the City Council's Finance Committee, Director of Finance, and Personnel Director), three individuals elected by members of the System (both current employees and retirees), and one public member selected by the other six.

SCERS has established investment policies that allocate funds among various asset classes, including U.S. stocks, international stocks, U.S. bonds, real estate, hedge funds, mezzanine debt (debt instruments of companies that are less risky than stock but are subordinate to bank loans or other traditional financing), and venture capital. Investment managers are selected for each of these areas based on past performance. According to the System's investment valuation consultant, SCERS invests somewhat more conservatively than most large public pension funds due to a smaller asset allocation to U.S. stocks. More details, including the latest quarterly investment performance assessment, can be provided if desired.

10. How has the investment philosophy and/or strategy changed over the past twenty years? There have been many changes in asset allocations and individual fund managers over the last 20 years. However, two changes are most significant. First, while the total share of the portfolio invested in equities (stocks) has not changed dramatically, the mix has. The System now has about 20% of the total portfolio invested in non-U.S. stocks and 38% in U.S. stocks. This represents a recent shift of about 10% of the portfolio from U.S. to

international stocks, consistent with the general sense that foreign stock markets offer more opportunities in the next few years. In addition to this shift, stock investments are now spread over a wider array of companies, including smaller firms, whereas investments tended to be concentrated in larger firms 20 years ago.

Second, the System has reduced the share of its assets invested in debt (typically U.S. corporate bonds). The System's actuarial assumptions expect it to earn an average of 7.75% per year. Bond returns have been far below this for many years as interest rates have fallen. Thus, money has been shifted away from bonds to higher-yielding investments with similar risk, such as mezzanine and hedge funds.

11. Has the law changed on how the investments can be done? No.

12. How does the City decide what to investment in, and what resources are used to make this decision? Again, these decisions are made by SCERS, not the City.

Investment decisions are made through a three-step process. First, the System hires a consultant to do an "asset allocation study" every two or three years. This study examines the projected returns and risks associated with different types of investments (U.S. large company stocks, real estate, venture capital, etc.) and develops overall mixes of asset classes to achieve a desired return at the lowest projected risk. A study of this type provided the rationale for the shift from U.S. to international stocks described previously.

Second, the System periodically issues Requests for Proposals (RFP) for various asset classes. For example, SCERS might issue an RFP to find managers who specialize in investments in U.S. corporate bonds. Proposals are reviewed and funds are provided to the selected managers based on their past performance and proposed investment strategies.

Third, SCERS regularly monitors investments and shift funds among them as needed. Managers who are not performing as expected are put on a "watch list" and are eventually terminated if performance does not improve. In some cases, managers are terminated immediately if a firm faces either legal or staffing issues.

SCERS is assisted in its investment decisions by a performance tracking firm (PCA) and an Investment Advisory Committee of outside experts.

13. What is the history of contribution level adjustments and the reason for the adjustment? Contribution rates through the 1960s and 1970s varied depending on hiring date, but typically were around 5% for both the employee and the employer. Pension systems received less oversight in that era so SCERS had a large unfunded liability. In the early 1980s, rates were increased to 8.03% for employees and 8.91% for the City to try to reduce the large unfunded liability. This was successful and by the late 1990s the System neared full funding. At that time, the City and its unions agreed to a series of benefit increases, such as the 1.5% annual COLA for employees retiring after January 1, 1998, and to lower the City's rate to 8.03% (the same as the employee rate). Rates have not been changed since.

14. Is it legal to have different bargaining units (employees) pay different amounts into the Retirement System? The current ordinance envisions a single system for all participating employees (uniformed police and fire employees are not members of SCERS and instead participate in State-operated plans). It might be possible to have different

systems for different bargaining units that had different benefits and contribution rates. This would be complicated to administer, especially for employees who moved from one unit to another. There are also federal laws governing equity in benefits that might restrict this flexibility. Exploring this option would require significant legal, financial, and administrative analysis.