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San Luis Obispo County
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SLOCPT

Memo

From: Carl Nelson, Executive Director

Date: September 6, 2023

Subject: **Unfunded Actuarial Liability (UAL)**

Recent articles on the level of Unfunded Actuarial Liability (UAL) of the San Luis Obispo County Employees Retirement Plan have raised awareness of this issue.

The SLO County Retirement Plan is administered by the San Luis Obispo County Pension Trust (SLOCPT), an independent trust formed in 1958 for that purpose. The information on the UAL is from the **2023 Annual Actuarial Valuation** that is published on the SLOCPT.org website. See the link below to the 2023 Actuarial Valuation as well as to the **2022 SLOCPT Annual Comprehensive Financial Report**. Both documents provide transparent and thorough reporting on the status of the SLO County Retirement Plan.

SLOCPT - 2023 Actuarial Valuation
SLOCPT - 2022 ACFR

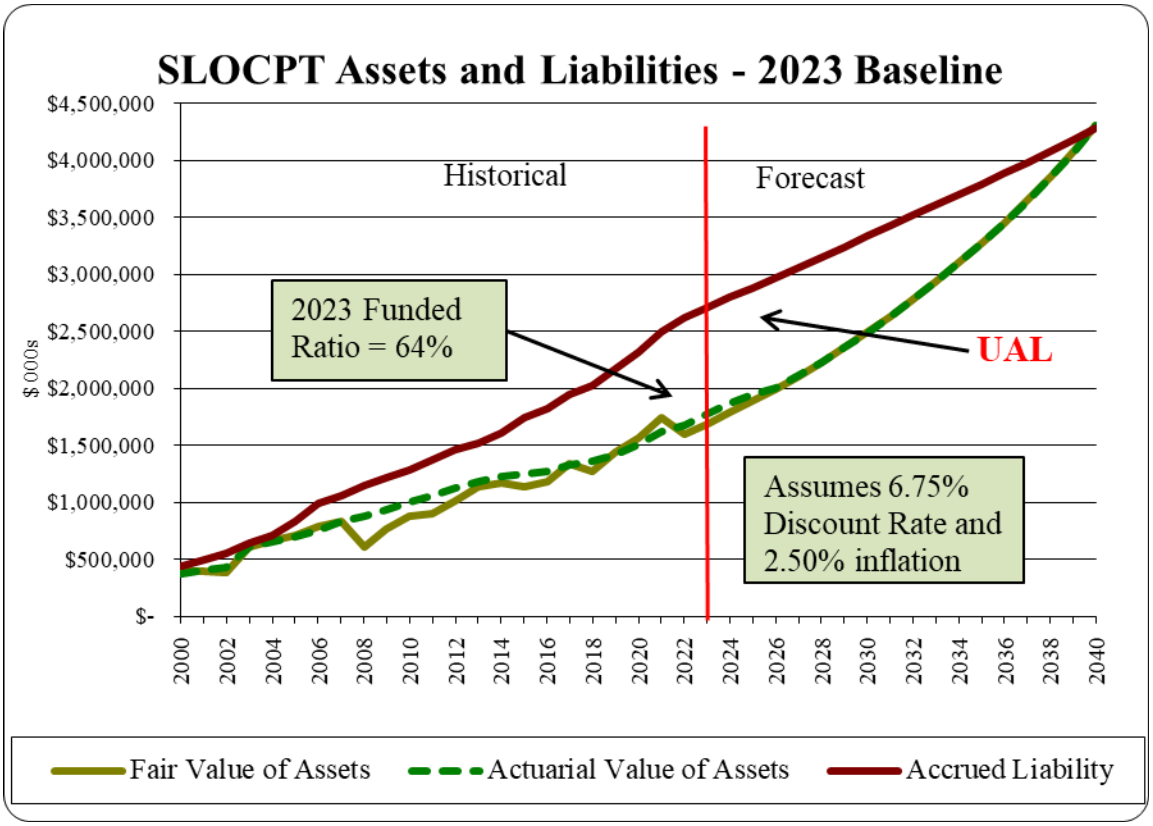
What is the UAL as of January 1, 2023?

Actuarial Liability	$ 2,622 million	(at a 6.75% Discount Rate)
Actuarial Value of Assets	$ 1,679 million	(AVA = 5-year smoothed value)
Unfunded Actuarial Liability	$ 943 million	Funded Ratio = 64.1%

Defined Benefit (DB) Pension plans exist to pay promised pension benefits to employees as part of their total compensation (pay + health insurance + pension, etc.). DB pensions collect contributions from both the Employer (39.5% of pay) and the Employees (13.3% of pay) and invest those funds to eventually pay the promised pension benefits. In the long run, investment earnings are expected to cover about 60% of the cost of the pensions – hence the reason for prefunding.

DB pensions are inherently very long-term in scope, and they are rarely right at a $0 UAL or a 100% funded ratio. Investment markets fluctuate and the underlying actuarial assumptions – such as the Discount Rate used to compute liabilities – change over time. The demographic experience of the Plan also changes - life expectancies keep increasing, pay increases and the growth in total payroll will differ from the initial assumptions of the actuary, etc.

Importantly, the actuarial standards for "paying down" the UAL have tightened significantly since 2010. Current practice is to fund pensions such that the UAL is amortized down to zero over a 20-year horizon. This leads to a systematic plan to reduce the UAL to $0 by approximately 2040. The history and the latest forecast for the UAL are shown in the following graph.



What Causes the UAL to Increase?

In the 2023 Annual Actuarial Valuation the Plan Actuary, Cheiron, calculated the sources of growth in the UAL over the last ten years from 2014 through 2022 (the base year for the 2023 Actuarial Valuation). During this period the UAL increased by $596 million attributable as follows:

$180 million **Investments**

The 10 year actuarially calculated return on the fund was at an annual rate of 6.2% versus the assumed rate of return – the Discount Rate – of 7.25% to 6.75% over this period.

$222 million **Assumption Changes**

This is the largest factor in the UAL increase. Assumptions include mortality rates, rates of retirement, pay increases, etc. The dominant actuarial assumption is the **Discount Rate** *. The decline in the Discount Rate from 7.25% in 2014 to 6.75% in 2023 had a large effect.

$147 million **Liability Gains/Losses**

These occur when the actual experience of the Plan differs from what was expected initially by the actuary. Examples include: increases in longevity – retirees living longer than expected; COLA adjustments to retirement benefits being higher than the long term assumption (COLAS are capped at 3% for Tier 1 retirees and 2% for Tier 2 & 3 retirees); or pay growth being different than expected.

$ 47 million **Contributions less than interest on the UAL**

In the early years of this 10-year period UAL payments were still catching up to the annual growth in the UAL from interest. Currently UAL funding is above the "tread water" mark and the principal of the UAL is being reduced each year (although other changes like those above can change the UAL significantly).

$ 596 million **Total UAL increase 2014-2022**

* **Discount Rate** – the rate used to discount future pension costs to the present to compute the Actuarial Liability and necessary pension contribution rates. This rate is extremely sensitive to even small changes given the very long-term nature of the cashflows being discounted.

This is also the **Expected Rate of Return** on the pension fund. Throughout the period from 2012 through 2023, on the advice of SLOCPT's investment Consultant and the Plan Actuary, the Board of Trustees have decreased the Expected Return / Discount Rate from 7.25% in 2014 to 6.75% in 2023. The primary influence on this decline has been the persistently suppressed interest rates by the Federal Reserve following the Global Financial Crisis of 2008. By using "easy money" to encourage economic recovery, the Fed effectively slashed the returns of balanced investors like pension funds who need to invest in bonds for the sake of diversification. The 2022 normalization of Fed monetary policy and the increase in bond interest rates created large losses in 2022 but should improve future expected returns.

What are the Pension Contribution Rates needed to fund the Plan?

Pension contribution rates are expressed as a percent of total payroll. DB pensions are indeed an expensive employee benefit. The intent of DB pensions is to provide meaningful retirement income as a valuable incentive to recruit and retain qualified employees to serve the public. By comparison, Defined Contribution plans like corporate 401(k)s are only tax-deferred savings vehicles - not pensions - with a frequently inadequate and outlived link to retirement income.
The 2023 Actuarial Valuation calculates the Actuarially Determined Contribution (ADC) as a percentage of pay to be –

	Employer	Employee	Total
Normal Cost (annual cost)	7.9%	13.3%	21.2%
Administrative Costs	1.0%	-	1.0%
UAL Amortization	30.6%	-	30.6%
Total ADC	**39.5%**	**13.3**%	**52.8**%

It is important to note that SLO County has bargained with its unions over the past 10+ years to share pension costs with employees at a steadily increasing amount. The share of pension contributions paid by SLO County employees at 13.3% of pay is well above California averages for other pension systems.

How has Pension Reform changed the outlook for DB pensions in California?

Beginning in 1999 public sector pension benefits in California were expanded in a surplus of optimism about their long-term cost. The result was the statewide adoption of retirement formulas similar to the SLO County Plan's "**Tier 1**" pensions. As the unsustainable nature of such benefits became apparent, Governor Brown led efforts at pension reform.

The SLO County Retirement Plan was out in front of pension reform when the Board of Supervisors adopted the reduced "**Tier 2**" pension benefits for new hires starting in 2011.

The statewide pension reforms resulted in the **Public Employee Pension Reform Act** of 2012 (PEPRA). This required reduction of all public sector retirement plan benefit formulas to what in SLO County is called the "**Tier 3**" pension benefit. This is sometimes referred to in other pension systems as the "PEPRA Tier". Tier 3 applies to all new hires starting in 2013.

As employees in the older Tier 1 pension benefit formula retire or leave, the cost structure of the SLO County Plan is evolving to the lower cost of the Tier 3 benefit. **At present, 63% of the active employees are in the Tier 3 pension benefit**.

Following the planned full "pay down" or amortization of the UAL by approximately 2039-2042, the current baseline forecast from the Plan Actuary is that the total ADC for the Plan will be just the Normal Cost component of about 20% of pay.

What are pensions based on?

Like most DB pensions, the SLO County Retirement Plan adopted by the Board of Supervisors and part of multiple collective bargaining processes with unions pays pension based on –

Years of Service * multiplied by
Final Average Salary ** multiplied by
Retirement Factor ***
= Basic pension benefit paid for life

* Years of actual service, full or part time, calculated down to the actual hours

** Final Average Salary (FAS) =
Highest 12-month average for **Tier 1** (hired before 2011) or
Highest 36-month average for **Tier 2** (hired 2011-2012) or
Highest 36-month average for **Tier 3** (hired 2013 or later)

FAS does not include overtime, accrued vacation or sick leave payouts. SLO County is one of the most restrictive pension plans in terms of the type of pay pensions are based on.

*** Retirement Factor varies with age at retirement, Class, and Tier – examples include

Miscellaneous (general) =	2.00% at age 55 Tier 1 or 2.00% at age 62 Tier 3
Safety =	3.00% at age 50 Tier 1 or 2.70% at age 57 Tier 3

There are different pension formulas (the Retirement Factor) for different Classes of employees –

Miscellaneous - general employees,
Safety - (different formulas for "Sworn" deputies and "Non-Sworn" correctional deputies)
Probation – probation officers

Within each Class there are three Tiers of pension formulas

Tier 1 - hired before 2011	currently 28% of active employees
Tier 2 - hired 2011-2012	currently 9% of active employees
Tier 3 - hired 2013 or later	currently **63%** of active employees – the "PEPRA" Tier

What are the levels of pensions being paid?

Recent articles highlighted the largest pensions being paid by the SLOCPT – those above \$200,000/year. This information is public information and readily available on websites like Transparent California that make Public Records Act requests of retirement systems and publish the data in a searchable form. Summary information on pension benefits is also readily available in the 2022 SLOCPT ACFR in the Statistical Section.

As the preceding section described, pension benefits are based on the length of service of an employee, their pay level and their age at retirement. Long-term SLO County employees who have spent an entire career of 30-40 years serving the public may earn relatively large pension benefits. If such long-term employees were highly compensated – a Department Head for example – their pension benefit can exceed \$100,000/year. Pension Benefits in the SLO County Retirement Plan are capped at 80% to 100% of Final Average Salary depending on which job class and tier the employee is in. The 2022 SLOCPT ACFR shows in the Statistical Section that there are currently 181 retirees receiving pensions greater than \$100,000 out of the 3,236 total retirees.

The average pension benefit for retirees as of January 1, 2023 was \$40,113/year. For the 139 new retirees in 2022 the average pension benefit was \$43,112/year.