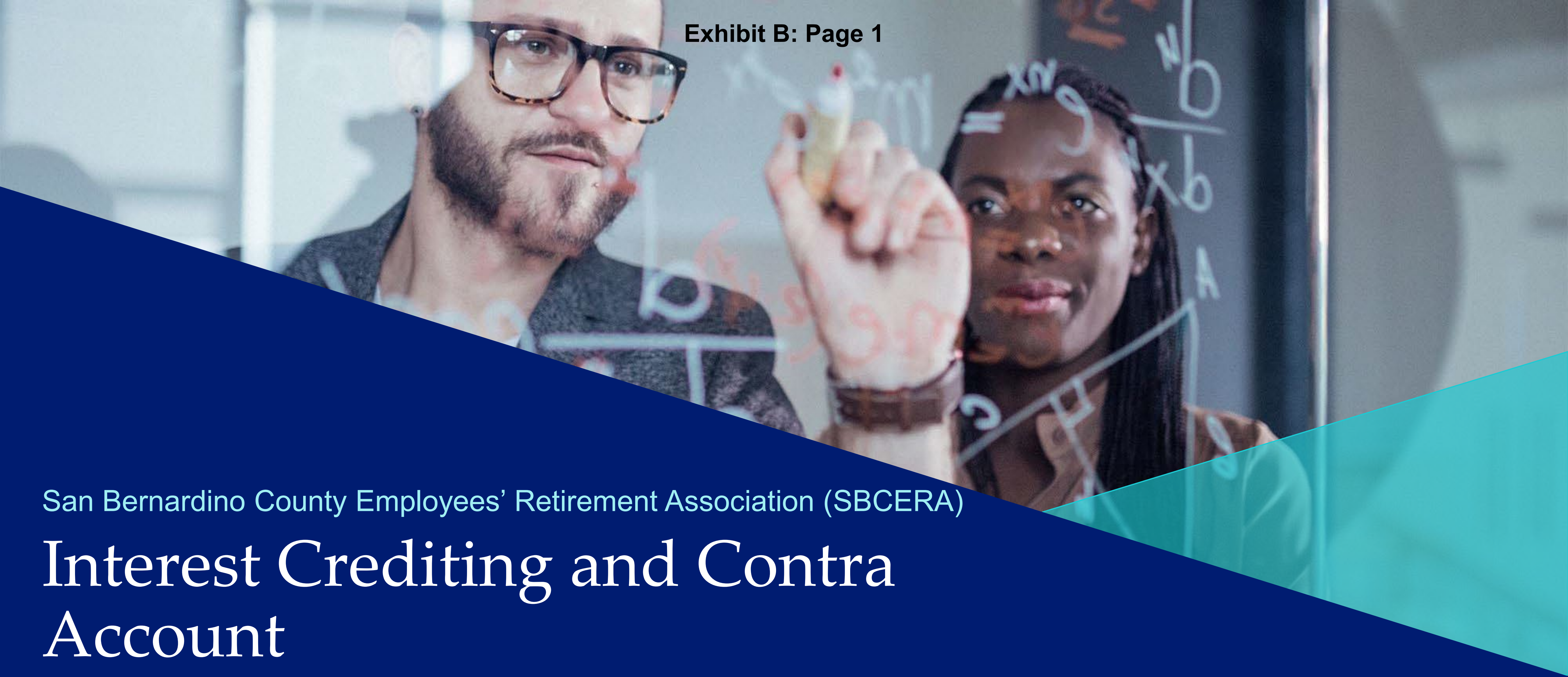


San Bernardino County Employees’ Retirement Association (SBCERA)

# Interest Crediting and Contra Account

## Revisited

November 7, 2024 / Todd Tauzer, FSA / Molly Calcagno, ASA



Segal

# Agenda

Interest Crediting, Excess Earnings, and the Contra Account

Difference between Unfunded Actuarial Accrued Liability (UAAL) and Contra Account

Board Considerations for the Contra Account

Board Considerations for a Purchasing Power COLA

# Interest Crediting and Excess Earnings Policy

*Background*

## What governs our Interest Crediting?

- Reserving procedures for assets required by 1937 CERL
  – Interest credited to reserves every six months
- SBCERA's Interest Crediting Procedures and Undesignated Excess Earnings Allocation Policy
  – Calls for crediting reserves at 7.25% current assumed valuation interest rate*
    - Available earnings determined using 5-year smoothed earnings
  – Establishes Contra Account before "excess earnings" are determined
    - Which under the CERL can be used for a purchasing power COLA

* Member account balances credited at lesser of assumed valuation interest rate or the six-month T-bill rate (not less than zero).

# How do we Work Toward Available Earnings?

*5-year asset smoothing example*

## One Good Year

| | Year | | | | | |
|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 |
| **MVA Return** | 12% | 7% | 7% | 7% | 7% | 7% |
| **Deferred** | (5%) | | | | | |
| **Recognized** | 1% | 1% | 1% | 1% | 1% | ___ |
| **AVA Return** | 8% | 8% | 8% | 8% | 8% | 7% |

Illustrated using a 7.00% assumed earnings rate
Note: SBCERA's assumed earnings rate is 7.25%

# How do we Work Toward Available Earnings?

*5-year asset smoothing example*

## One Good Year, then One Bad Year

| | Year | | | | | | |
|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 |
| **MVA Return** | 12% | 2% | 7% | 7% | 7% | 7% | 7% |
| **Deferred** | (5%) | 5% | | | | | |
| **Recognized** | 1% | 1% | 1% | 1% | 1% | | |
| | ___ | (1%) | (1%) | (1%) | (1%) | (1%) | ___ |
| **AVA Return** | 8% | 7% | 7% | 7% | 7% | 6% | 7% |

Note: SBCERA's assumed earnings rate is 7.25%

# Interest Crediting and Excess Earnings Policy

*The process*

## Determine Available Earnings for the period

- Using:
  - All current period earnings on Actuarial Value of Assets (smoothed basis)
  - Prior year's balance in the Restricted Balance Reserved for Deficiencies (RBRD) and Additional Contingency Reserve (ACR)

## Determine earnings required for statutory interest crediting

- Applied to valuation reserves
- Using current investment return assumption as the interest rate

# Interest Crediting and Excess Earnings Policy

*The process*

## If Available Earnings fully satisfy reserves

- Credit remaining earnings in this order:
  - Restore Contra Account to zero
  - Restore 1% RBRD
  - Restore 2% ACR
  - Allocate remaining Available Earnings to Undesignated Excess Earnings
    - Increase ACR above 2%
    - Transfer to valuation reserves to increase funding of statutory benefits

## If Available Earnings are insufficient (or negative)

- Credit reserves anyway
  - Increase Contra Account by any shortfall as the balancing item

# Interest Crediting and Contra Account

*What is this again?*

## The Contra Account

- Established to track interest crediting shortfall on a cumulative basis
  - When actual 5-year smoothed earnings fall short compared to assumed rate, shortfall added to the Contra Account
  - Any Contra Account balance must be made up by future excess (undesignated) earnings
    - In other words, future excess earnings must first be used to “zero out” prior shortfalls tracked in the Contra Account
    - Other conditions must also be met, including restoring RBRD to 1% and ACR to 2% of assets
- This prevents excess earnings from skewing gains and losses

# Interest Crediting and Contra Account

*What is this again?*

## Contra Account Basic Example

- Tracking earnings on a cumulative basis
  - Difference comes when a good year follows a bad year
    - Scenario X: earn 7.25%, then 7.25%
    - Scenario Y: earn 0.00%, then 14.50%
      - For this example, forget about the RBRD, ACR, asset smoothing and compounded interest
  - Should excess earnings be any different in these scenarios?
    - Without Contra Account, Scenario Y would have excess earnings in year 2 by ignoring the shortfall in year 1
    - With Contra Account, neither Scenario results in excess earnings
      - In Scenario Y, 7.25% shortfall in year 1 tracked in Contra Account
      - No excess in year 2 as 14.5% used to credit 7.25% interest and then zero out the 7.25% Contra Account
      - Cumulatively, no excess over both years

# Interest Crediting and Contra Account

*Additional considerations*

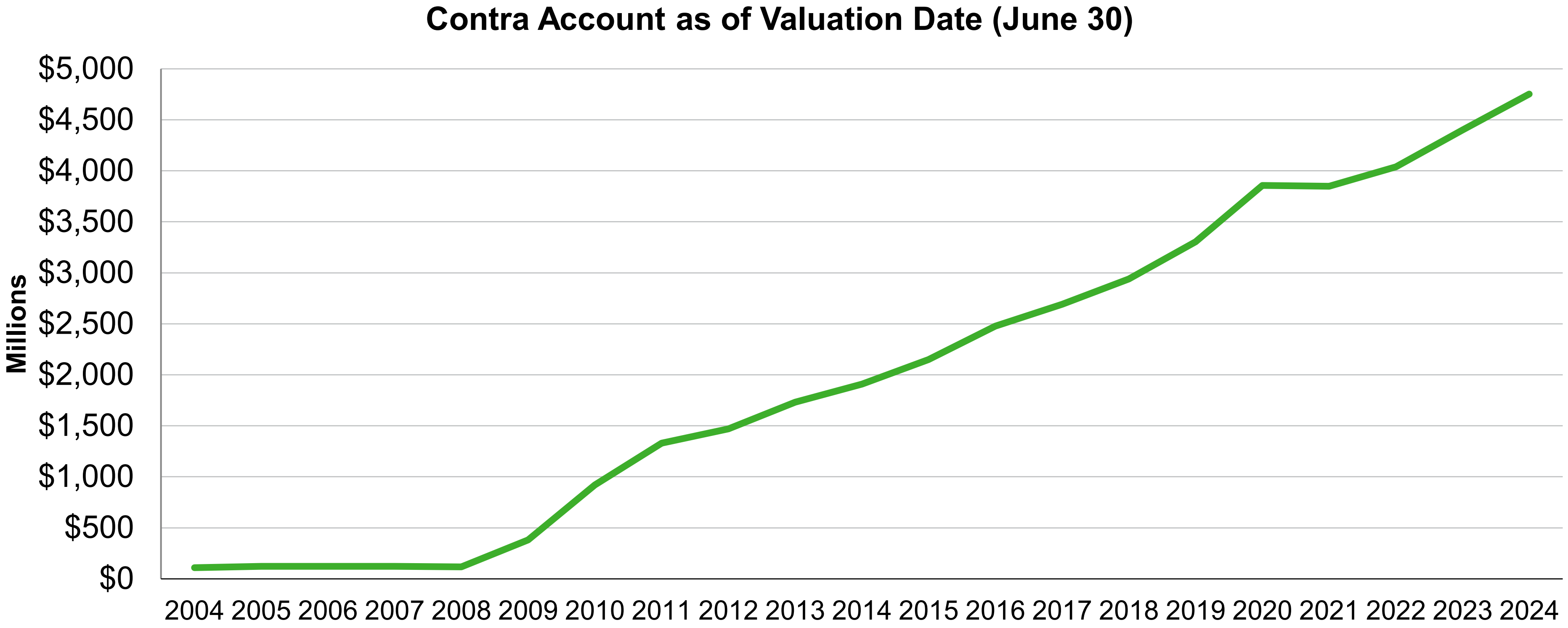
## Using the Contra Account has its own nuances

- Amount tracked is heavily dependent on when it was started
- Any balance in the Contra Account also grows with interest
- Total balance only zeroed out when plan earns the expected earnings on a cumulative basis, including any interest on past shortfalls

# SBCERA's Contra Account

*The specifics*

- Current balance is $4.75 billion at 6/30/2024
  – Largest balance since creation
- Path to current balance started from $108.5 million at 6/30/2004



# Differences Between UAAL and Contra

*Funding versus reserving*

## The Contra Account (reserving)

- Only affected by investment earnings, ever
- Only exists to measure excess earnings on a cumulative basis

## The UAAL (funding)

- Measures the actual funding of benefits
- Tracks all changes in assets and liabilities, including contributions, investment and demographic gains/losses, and assumption changes
  - In particular, UAAL is reduced by UAAL contributions paid by employers
  - Plan could be in surplus but still track prior investment losses in Contra Account

# Difference Between UAAL and Contra

*Contra across time*

## Changes in Contra Account

- Balance increased from $108.5 million (6/30/2004) and peaked at $4.75 billion (6/30/2024)
- Employer contributions, favorable non-investment experience and benefit reforms do not affect the Contra Account
  - Contra Account zeroed out only after plan earns more than assumed on cumulative basis since 2004
- Favorable investment experience alone reduces Contra Account (e.g., $3.86 billion in 2020 to $3.85 billion in 2021)
  - Decreases unlikely, as current interest burden creates major headwinds

# Difference Between UAAL and Contra

*UAAL across time*

## Changes in UAAL

- UAAL increased from $302 million (6/30/2004),
  peaked at $3.17 billion (6/30/2020)
  and has since dropped to $2.21 billion (6/30/2024)
- Decrease in UAAL from 6/30/2020 to 6/30/2024 is primarily due to employer contributions and favorable non-investment and investment experience
- SBCERA anticipates further decreases to come

# Possible Action on Contra Account

*For the Board's consideration*

## Should the Board zero out Contra Account at full funding?

- Zeroing out Contra Account means setting total reserve balances equal to valuation value of assets
  - No change to UAAL or employer and employee contribution requirements
  - Enables the possibility of future excess earnings (but no free lunch!)
- Zeroing out Contra Account is heavily sensitive to timing of future gains and losses
  - If in the next year SBCERA earns more than 7.25%, then excess earnings would be available immediately
    - After restoring RBRD to 1% of assets and ACR to 2% of assets
  - If in the next year SBCERA earns less than 7.25%, then Contra Account will be reestablished again

# Purchasing Power COLA

*Possible paths forward*

## Providing through future excess earnings?

- Excess earnings is not a reliable funding source (skews funding)
  - If SBCERA earns less than 7.25% in a year after purchasing power COLA was granted in a prior year
    - Employer's UAAL contributions in the year will go up to:
      (a) explicitly pay for the investment losses and
      (b) implicitly pay for the purchasing power COLA

## Besides excess earnings, what other means are available?

- Other 1937 CERL retirement systems have used Section 31874.3
  - Employers have to agree to pay for the ad-hoc COLA (as part of the UAAL) before they may be granted by their retirement boards

# Questions?