LACERA

January 28, 2013

TO: Each Member
Board of Investments

FROM: Gregg Rademacher
Chief Executive Officer

FOR: February 13, 2013 Board of Investments Meeting

SUBJECT: **RETIREMENT BENEFIT FUNDING POLICY AMENDMENT**

RECOMMENDATION

1. Amend the Retirement Benefit Funding Policy to conform with new standards mandated in the California Public Employees' Pension Reform Act of 2013, and

2. Evaluate the Retirement Benefit Funding Policy provision excluding STAR Reserve amounts from valuation assets.

EXECUTIVE SUMMARY

PEPRA

Effective January 1, 2013 the California Public Employees' Pension Reform Act of 2013 (PEPRA) dictates specific retirement benefit funding provisions enforceable upon LACERA. Specifically, PEPRA prohibits LACERA reducing contributions for a participating employer, such as the County of Los Angeles (County), when the plan's funded status is below 120%. Staff recommends amending the LACERA Retirement Benefit Funding Policy (Funding Policy) to raise the contribution reduction threshold from the current 100% funded status to the PEPRA mandated 120% funded status.

STAR Reserve

At the October 12, 2011 meeting, the Board of Investments (Board) directed staff to provide information on modifying the Funding Policy with respect to the STAR Reserve and securing an indemnification from the County to include the STAR Reserve as a valuation asset in performing the 2012 valuation and beyond. This is an important issue, as making an exception to include the STAR Reserve as a valuation asset lowers the required employer contribution. This practice began in 2002 as a temporary funding policy that was to sunset with completing the 2008 actuarial valuation. Accordingly, the current Funding Policy, adopted in 2009, requires the STAR Reserve to be excluded from valuation assets. In each valuation performed since adopting

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the Funding Policy (specifically the 2009, 2010, and 2011 valuations), the Board of Investments made an exception to include the STAR Reserve as a valuation asset to provide the County funding relief. In response to the Board's request for indemnity, the County agreed to indemnify LACERA and is requesting the Board to continue including the STAR Reserve as a valuation asset as they recover from their current fiscal crisis. Staff believes LACERA should apply its policies consistently. As such, staff recommends the Board should follow the funding policy and exclude the STAR Reserve on a consistent basis or amend the policy to include the STAR Reserve as a valuation asset for a set period of time or in perpetuity. Should the Board desire to change the Funding Policy or make an annual exception to include the STAR Reserve as a valuation asset in performing the June 30, 2012 valuation, the Board needs to document satisfying its duty of loyalty and prudence to plan members.

INTRODUCTION

In 1994, the County issued $2 billion in pension obligation bonds to fully fund the LACERA retirement benefit plan. This required a Retirement System Funding Agreement (Funding Agreement) between the County and the Board establishing the retirement system's funding policy for the next 15 years. With completing the June 30, 2008 retirement benefit actuarial valuation, the Funding Agreement's terms dictating funding policy, including the treatment of the STAR Reserve, became unenforceable. As such, the Board adopted a Retirement Benefit Funding Policy (Funding Policy) in November 2009 to provide LACERA's plan actuary direction in performing retirement benefit actuarial valuations.

CALIFORNIA PUBLIC EMPLOYEES' PENSION REFORM ACT OF 2013

On January 1, 2013 the California Public Employees' Pension Reform Act of 2013 (PEPRA) changed retirement benefit plan administration for public defined benefit plans across California. One aspect is restricting a pension plan's ability to reduce an employer's contribution when the plan is well funded. LACERA's current benefit funding policy, adopted by the Board of Investments in November 2009, provides the Board the ability to reduce the employer's contribution should the plan meet or exceed the 100% Funding Goal. This Board policy is now in conflict with California state law. PEPRA allows the Board of Investments to reduce contributions when the following three conditions in §7522.52 all apply:

1. The plan is more than 120% funded,
2. The plan actuary determines continuing to accrue excess earnings could result in the Internal Revenue Service revoking the plan's tax qualified status, and

3. Receiving additional contributions will be in conflict with the Board's fiduciary duty as defined in the California Constitution's Article 16 - Section 17.

   (Note – Section 17 is also commonly referred to as Prop 162 and is attached for your information.)

The attached Retirement Benefit Funding Policy has been modified to make specific reference to the 120% funding threshold and the need to meet §7522.52 requirements. Should the Board of Investments at a future date consider suspending contributions, the Board will need to build the public record for meeting the three requirements. Staff recommends your Board adopt the Retirement Benefit Funding Policy revisions as presented.

STAR COLA RESERVE AS A VALUATION ASSET

Before the Board is a request to evaluate the Funding Policy's Section 11.2.(e) defining Valuation Reserves. Valuation Reserves represent the assets the actuary compares to the plan liabilities when calculating contribution rates and determining the plan's funded status. While LACERA has a variety of reserves, they must be segregated between Valuation Reserves (assets counted when setting contribution rates) and Non-Valuation Reserves (assets not counted when setting contribution rates). The current funding policy defines our reserves as follows:

LACERA Reserves
As of June 30, 2012
(in millions)

Valuation	
Member	$15,707
Employer	$20,382

Non-Valuation	
Advanced Employer Contribution	$0
Contingency	$136
County Contribution Credit	$471
STAR	$614

Traditionally, the Non-Valuation reserves were excluded as they represent assets set aside for special benefits to be funded outside of actuarially determined contribution rates (STAR), the payment of future expected contributions (Advanced Employer Contribution and County Contribution Credit) , or for fiscal emergencies (Contingency).

This changed in 2002, when the Board amended the 1994 Funding Agreement to allow a portion of the STAR Reserve to be counted as a valuation asset. This action raised the actuarial value of assets thus decreasing the employer's contribution rate and ultimately lowering the employer's contribution payment into the retirement system. At the conclusion of the 1994 Funding

Agreement, the Board adopted a Funding Policy in 2009 excluding the STAR Reserve from valuation reserves. The Board, with advice from its experts, made exceptions to this policy and included the STAR Reserve as a valuation asset in performing the 2009, 2010, and 2011 actuarial valuations. Since the practice of including the STAR Reserve as a valuation asset started in 2002, the County has enjoyed deferring over $360,000,000 in employer contributions. Adjusting this deferred payment stream for actual portfolio returns, staff estimates the impact to the LACERA investment portfolio at approximately $480,000,000.

During the 2011 actuarial valuation deliberations, the Board requested staff to provide information on modifying the Funding Policy with respect to the STAR Reserve, and on securing an indemnification from the County for including the STAR Reserve as a valuation asset. Using the Funding Agreement's 2002 amendment as a guide, LACERA suggested the following indemnification for the County's consideration.

> The County agrees to indemnify, save, and hold harmless LACERA, its Board Members, officers, and employees from and against any and all liabilities, losses, suits, costs, charges, judgments, expenses, and attorneys' fees (at both the trial and appellate levels), and claims for damages of any nature whatsoever, that arise from, are connected with, or relate to including the STAR Reserve as an actuarial asset in determining plan funding and setting contribution rates.

The attached letter from Los Angeles County's Chief Executive Officer, William T Fujioka, requests the Board to include the STAR Reserve as a valuation asset, consider writing this into the Funding Policy as it was in the Funding Agreement's 2002 amendment (for a specified time period while the County recovers from their current fiscal crisis), and the willingness to indemnify LACERA as it did in the Funding Agreement's 2002 amendment.

Historical Perspective

When the Board deliberated to include the STAR Reserve as a valuation asset in the 2009, 2010, and 2011 valuations, there were two primary issues to address:

- Did the Board have discretion to count the STAR Reserve as a valuation asset?
- Could the Board satisfy its duty of loyalty and prudence to plan members in deciding to include the STAR Reserve as a valuation asset?

At the conclusion of Board deliberation, the Board determined it did have the discretion to count the STAR Reserve as a valuation asset and it had satisfied its duty of loyalty and prudence to plan members.

At that time, the Board considered the County's request for the Board to include the STAR Reserve as a valuation asset based on the County's assertions that failing to continue including the STAR Reserve would have significant financial consequences that would impact County resources needed for County jobs. It was the County's hope their financial condition would improve during 2011 and 2012 and provide them the ability to plan and budget for rising retirement plan costs.

Satisfying the Board's Duty of Loyalty and Prudence to Plan Members

The Board will need to satisfy its duty of loyalty and prudence to plan members in deciding to modify the Funding Policy to include the STAR Reserve as a valuation asset or provide an annual exception to include the STAR Reserve as a valuation asset in performing the June 30, 2012 valuation. The attached memorandum from LACERA's Chief Legal Counsel, Robert Van Der Volgen, provides the legal framework for addressing the STAR Reserve issue and questions to consider when deliberating. The following discussion presents my perspective on these questions as a starting point for your deliberation.

Questions for Consideration

1. The potential need for using the STAR Reserve to pay STAR COLA benefits.

   Low inflation experienced in the past three years created a condition where LACERA will not be granting additional STAR COLA benefits for calendar year 2013. Based on the current cost-of-living bank balance used to qualify for STAR COLA benefits and the consumer price index averaging 2% in the prior calendar year, it is foreseeable that the statutory COLA will cover short-term inflation damage, and no additional STAR COLA benefits will be granted for calendar year 2014. It is estimated that retirees at greatest risk, Plan A members with retirement dates prior to April 1, 1980, would need to suffer inflation at a level greater than 10.5% to create the condition where these retirees may be eligible for additional STAR COLA benefits. As Plan B, C, & D members have lower COLA benefits, their inflation threshold is lower at 5.5% for members with retirement dates prior to April 1, 1989 (Plan E members are not eligible for STAR COLA benefits.) It must be noted that we are living through an unusual low inflationary environment and additional STAR COLA benefits were not granted for the 2010, 2011, and 2012 program years. When the STAR Program was created in 1990, Plan A retirees under the 3% maximum annual COLA program had already suffered over 68% inflation damage beyond their 3% annual inflation coverage. Economic experts predict that it is simply a matter of time before America suffers another rising inflation cycle. Staff does not foresee an immediate short term need for STAR Program funding, however, it is reasonable to expect the STAR Reserve funds will be used by the Board of Retirement to address future inflation damage.

2. What mechanism, if any, is available to cover any gap in the UAAL as a result of paying STAR COLA benefits?

   While it can be argued that using the STAR Reserve as a retirement benefit valuation asset and as a funding source for STAR COLA benefits creates a condition where the County is not sufficiently contributing for retirement benefits, there is no unfunded actuarial accrued liability (UAAL) for retirement benefits created until such time as the STAR Reserve is actually used to fund STAR COLA benefits. The resulting funding gap would be recognized as an actuarial loss to be paid by the County through increased employer contributions over a 30-year period or until such time as the plan's funding level reaches 100%. Alternatively, the County could make additional contributions to the plan at anytime to improve the funding level.

3. What are current funding trends?

   Public pension plans continually assess their actuarial assumptions in light of actual experience and expectations of future experience. There is a growing trend for public pension plans to view their economic assumptions more conservatively and to implement more conservative funding methodologies, such as asset smoothing and amortization periods. Recognizing a restricted reserve is not a common issue faced by public pension plans.

4. What are the current financial accounting trends?

   There is a trend to ensure transparency in plan funding. The Governmental Accounting Standards Board is requiring plans to measure and recognize all plan liabilities. As such, including a restricted asset, such as the STAR Reserve, in the funding of retirement benefits would infer that a corresponding liability should then also be recognized in the funding calculation. Recognizing a corresponding STAR liability negates the effect of lowering the employer's cost by recognizing the STAR Reserve as a valuation asset.

5. What is the impact on the active and retired plan beneficiaries?

   Including the STAR Reserve in the actuarial assets has no direct impact on active and retired member contributions or benefits. However, it could be perceived as having an indirect impact. For example, the active members may support including the STAR Reserve as it lowers the employer contribution rate, thus, providing resources to avoid employee layoffs and program curtailments. The active and retired members may not support including the STAR Reserve as it lowers the County's contribution rate, thus weakening the funding strength of the plan should inflation outpace the statutory cost-of-living benefit when the plan's funded status is below 100%.

6. What other funding may be available?

   There are no other funding sources for STAR COLA benefits beyond the discretionary allocation of excess earnings when the plan's funding level is greater than 100%.

7. What are the views of your actuary?

   The plan actuary believes this matter is a Board of Investments policy decision. However, if the Board of Investments decides the STAR Reserve will be included in the valuation assets without an offsetting liability, the actuary will provide supplemental report disclosures highlighting the artificial lowering of the employer contribution rate and the plan's funded status.

Reserves

The ownership of plan assets is accounted for through the use of reserve accounts. The majority of the reserves are held by members and the participating employers. These reserves are counted by the actuary in calculating the plan's funding status and setting contribution rates. The Funding Policy specifically excludes four reserves from being counted by the actuary as valuation assets for the purpose of determining the funding of the plan and setting the employer contribution rate. The excluded reserves are as follows:

Advanced Employer Contributions

County contributions paid in advance and already recognized by the actuary in the funding calculation as the expected future payments for normal cost contributions.

Contingency Reserve

A statutory reserve set aside for earnings deficiencies.

County Contribution Credit Reserve

Excess Earnings set aside to be used by the County for current and future employer contributions to LACERA. This reserve was created as part of the 1994 Funding Agreement and funded with 75% of the excess earnings generated during the period from 1994 through 1998. This reserve received over $3 billion in funding and has been drawn down upon by the County as a dollar-for-dollar offset to required employer contributions. Although this fund has not received additional funding since 1998, it does accrue interest when funds are available.

STAR Reserve

A reserve established by the Board to accumulate excess earnings for the purpose of paying STAR COLA benefits as approved by the Board of Retirement. This reserve received over $1 billion in funding under the 1994 Funding Agreement from 25% of the excess earnings generated during the period from 1994 through 1998 and has been drawn down upon by the Board of Retirement to pay STAR Program benefits. This reserve has not received additional funding since 1998 and does not accrue interest.

1994 Pension Obligation Bond's Retirement System Funding Agreement

Prior to the County contributing over $2 billion in pension obligation bond proceeds to LACERA, the County required a Funding Agreement defining how the retirement system would be funded from 1994 through 2009, and the 2002 amendment specifically addresses including STAR Reserves in valuation assets when conducting the 2002 through 2008 actuarial valuations.

> "Commencing with the annual actuarial valuation as of June 30, 2002, and in subsequent annual valuations through and including the valuation as of June 30, 2008, LACERA's actuary shall include in valuation assets funds in the STAR Cola Reserve in excess of the amount expected to be used between the valuation date and July 1, 2009, but only if such Funding Ratio is less than 100% without inclusion of such funds, and then only for the amount needed to reach a 100% Funding Ratio. Commencing with the valuation as of June 30, 2009, funds in the STAR Cola Reserve will no longer be treated as a valuation asset."

As previously mentioned, the Funding Agreement included dividing excess earnings between a reserve under the County's control (County Contribution Credit Reserve) and a reserve to serve as a funding source for STAR Program benefits (STAR Reserve). The 1994 Funding

Agreement's 2002 amendment clearly states that following the end of the agreement in 2009, the STAR Reserve

> "shall remain under LACERA's control and may be used by LACERA to pay STAR Cola benefits in the future."

No other agreement provisions expressly discuss the future use of the STAR Reserve or limit the Board of Investments' ability to transfer funds from the STAR Reserve to another reserve. However, LACERA counsel concluded the STAR Reserve is a protected funding source for the payment of STAR benefits and not available for non-STAR program uses beyond being the last dollars in the fund to pay benefits. The foundation for this argument being the improved STAR Reserve funding was one piece of a larger construct that included the retirees losing long term funding protection when the five (5) year amortization period was lengthened to 30 years and 75% of the excess earnings went to offset future contributions from the County. This quid-pro-quo cannot be undone without unraveling the entire agreement or providing an equally appealing alternative.

Civil Grand Jury

The Los Angeles County 2010 – 2011 Civil Grand Jury released a study of public pension plans operating within Los Angeles County. As one of five retirement systems selected for in-depth analysis, the Civil Grand Jury offered plan design recommendations for the Board of Supervisors and one funding policy recommendation concerning the STAR Reserve for the Board of Investments. The Civil Grand Jury believes including the STAR Reserve in valuation assets is appropriate; however, they found that in doing so without also recognizing a corresponding STAR benefit liability, LACERA is overstating the financial strength of the plan. The Civil Grand Jury's recommended solution requires creating a fictitious STAR liability to offset any STAR Reserve used in measuring the plan's financial strength. In other words, the Civil Grand Jury's perspective is that there is a high probability the STAR Reserve will be used over an extended period of time to pay STAR benefits and, as such, the STAR Reserve should be excluded from assets used to measure the plan's financial strength to pay retirement benefits.

Conclusion

The 1994 Funding Agreement's 2002 amendment began a "temporary" practice of counting the STAR Reserve as assets available to fund retirement benefits as a tool to lower the County's employer contribution. A new Funding Policy was adopted by the Board in 2009 removing the "temporary" practice and requiring the STAR Reserve be excluded as retirement benefit valuation asset. However, for the 2009, 2010, and 2011 valuations, the Board provided an exception, with advice from its experts, to provide the County with funding relief by including the STAR Reserve as a valuation asset to fund retirement benefits. The Board requested staff to provide information on modifying the Funding Policy with respect to the STAR Reserve and on securing an indemnification from the County for including the STAR Reserve as a valuation asset in performing the 2012 valuation and beyond. The County agreed to indemnify LACERA should the Board include the STAR Reserve as a valuation asset. Staff believes LACERA should apply its policies consistently. As such, staff recommends the Board should follow the funding policy and exclude the STAR Reserve on a consistent basis or amend the policy to include the STAR Reserve as a valuation asset for a set period of time or in perpetuity. Should the Board desire to change the Funding Policy or make an annual exception to include the STAR Reserve as a valuation asset in performing the June 30, 2012 retirement benefit valuation, the Board needs to document satisfying its duty of loyalty and prudence to plan members.

CONCLUSION

The Board uses the Funding Policy to document funding methodologies. This body of knowledge is relied upon by the plan actuary in completing the annual retirement benefit actuarial valuations. The Funding Policy requires modification to bring it into compliance with the new 2013 California pension reforms laws restricting contribution rate reductions when the plan's funded status is below 120%. Additionally, the Board requested staff to provide information on modifying the Funding Policy with respect to the STAR Reserve and on securing an indemnification from the County with respect to including the STAR Reserve as a valuation asset in performing the 2012 valuation and beyond. Staff is seeking your approval to amend the Funding Policy to bring the policy in compliance with the new pension reform laws.

IT IS THEREFORE RECOMMENDED THAT THE BOARD OF INVESTMENTS

1. Amend the Retirement Benefit Funding Policy to conform with new standards mandated in the California Public Employees' Pension Reform Act of 2013, and

2. Evaluate the Retirement Benefit Funding Policy provision excluding STAR Reserve amounts from valuation assets.

GR:nm
Funding Policy Amendment Memo January 2013.doc

Attachments

Los Angeles County Employees' Retirement Association

Retirement Benefit Funding Policy

Adopted by the Board of Investments
December 9, 2009

I. Funding Goal

The Funding Goal establishes the funding status the Board of Investments would like LACERA to achieve. The main goal is to provide benefit security for its members as well as to achieve and maintain stable employer contributions that are as low as possible.

Under the Entry Age Actuarial Cost Method, the cost of financing benefits is allocated over a member's working lifetime, with the goal that sufficient assets are accumulated to fund benefits by the time the benefits first become payable. LACERA allocates the cost of paying for the promised benefits evenly over time expressed as a percentage of payroll. Determining the cost as a percentage of payroll rather than level dollars provides intergenerational equity between taxpayers that reflects changes in inflation over time. The allocation of benefit financing to prior and future years is based on the cost method, with prior years' allocation equal to the Actuarial Accrued Liability (AAL) and the future years' allocation equal to Present Value of Future Normal Costs. Note that the actuarial cost method is an allocation of when to fund the benefits, not when they are being earned.

The Funded Ratio is the measurement of the Valuation Reserves to the AAL. When the assets available for funding (Valuation Reserves) equal the AAL, then LACERA is considered fully funded with a Funded Ratio of 100%. Assets in excess of those needed to reach 100% funding are considered excess funds for funding purposes. A Funded Ratio equal to 100% is the **Funding Goal**.

II. What Does the Funding Goal Mean for Setting Contribution Rates?

1. Funding Policy

The assets and the liabilities for both prior and future accrued benefits will be constantly changing based on experience, benefit changes, assumption changes, and other outside factors impacting LACERA benefits. Therefore, the Funding Policy will guide the Board as to what actions are expected to be taken in determining contribution rates to achieve the Funding Goal.

This policy is intended to provide guidance as to when adjustments to LACERA's contributions and funding for discretionary benefits should be considered by the Board of Investments. The Funding Policy is meant to assist in establishing a contribution rate which is relatively stable over the long term while LACERA provides its members superior retirement benefit security and minimizes both the size and volatility of the employer contributions.

When the Ratio of the Valuation Reserves to the Actuarial Accrued Liabilities is:

A. **Less than 100%** - the Funding Policy ~~would~~ requires a contribution rate equal to:

1) The Normal Cost Rate for the year, plus

2) A minimum 30 year amortization payment on the increase in UAAL due to the current year's experience and changes (current Yearly UAAL layer) plus

3) The sum of the amortization payments for each remaining Yearly UAAL layer created in years prior to the valuation date, expressed as a percentage of pay.

4) In no case shall the total amount contributed by the employer be less than the Normal Cost Rate for the year, plus a 30-year amortization of the total UAAL.

B. **Greater than 100% and less than 120%** - the contribution rate is the Normal Cost Rate. This conforms with California Government Code Section 7522.52 of the California Public Employees Pension Reform act of 2013.

~~B.~~C **Greater than ~~100~~120%** - the contribution rate is the Normal Cost Rate reduced by an amount equal to the amortization of the surplus, where the surplus is defined as the Valuation Reserves in excess of the Actuarial Accrued Liability on the valuation date. The surplus amount is amortized using a 30 year amortization period provided all conditions in California Government Code Section 7522.52(b) are met.

2. Guidelines and Terminology

(a) The Funded Ratio is calculated by dividing the Valuation Reserves by the AAL. It may be determined separately between the Active and Inactive members by first allocating Valuation Reserves to the Inactive AAL and then all remaining Valuation Reserves to the Active AAL.

(b) The Yearly UAAL layer is the difference between the expected increase in the UAAL due to the passage of time and the actual change in the UAAL due to the experience since the last annual actuarial valuation. The expectation is that each year's UAAL will be amortized and funded separately so that its ultimate payment is visible in the funding decisions.

(c) Once LACERA's Funded Ratio reaches 100% or more, then all prior Yearly UAAL layer amounts will be considered fully amortized and will no longer be considered in the determination of contribution rates.

(d) If, at some time after LACERA's Funded Ratio reaches 100%, but then the Funded Ratio, once again, drops below 100%, a new UAAL layer amount will be established in the first year equal to the new UAAL amount.

(e) Valuation Reserves are the actuarial value of the fund, less the value of any reserves which have been set aside for current liabilities and special benefits that are to be funded outside of the actuarially determined contribution rates. The '37 Act requires the Contingency Reserve be set at a minimum of 1.0% of assets. The STAR Reserve has funds set aside to provide supplemental COLA benefits to retired members. The County Contribution Credit Reserve contains funds allocated for allocation against future required County Contributions and the Advanced Employer Contribution Reserve includes advance funds paid by the County. These four Reserves are not part of the Valuation Reserves after July 1, 2009.

(f) The market value of total assets is used in calculating the actuarial value of the fund. Under the actuarial asset method, the market value returns are smoothed over a 5 year period to reduce contribution rate volatility.

III. Annual Implementation

1. Interest Crediting Policy For Reserves

In accordance with Section 31591 of the CERL, LACERA maintains various Reserve accounts for purposes of allocating the realized income and disbursements of the trust fund assets. As such, the balances are accounting balances and may not equal the Actuarial Value of Assets. For Reserve Accounting purposes, interest credits are allocated in the same priorities as listed for the allocation of actuarial assets but are based only on Realized Earnings for the period. Realized Earnings includes the net realized income plus any prior balance in the Contingency Reserve. The allocation of Realized Earnings is performed twice a year as of June 30 and December 31.

2. Allocation of Actuarial Assets

For funding purposes and for setting contributions rates, Recognized Earnings for a Plan Year is the recognized investment income as determined by the Actuarial Asset Method and includes both unrealized income and net realized income together with the prior balance in the Contingency Reserve. The allocation of Recognized Earnings is only performed once a year as of the Valuation Date in the following order of priority:

Priority 1: Allocate to the Member Reserve so the Actuarial Asset allocation to that Reserve equals the accounting value for that Reserve on the Valuation Date.

Priority 2: Allocate to the Advanced Employer Contributions Reserve so the Actuarial Asset allocation to that Reserve equals the accounting value for that Reserve on the Valuation Date.

Priority 3: Allocate to the Employer Reserve so the Actuarial Asset allocation to that reserve equals the accounting value for that Reserve on the Valuation Date.

Priority 4: Allocate to the County Contribution Credit Reserve so the Actuarial Asset allocation to that reserve equals the accounting value for that Reserve on the Valuation Date. Note: This Reserve is not a Valuation Reserve.

Priority 5: Allocate to the Employer Reserve so the total amounts allocated equal one year's interest at the assumed interest rate used in the actuarial valuation as of the preceding Valuation Date to the extent there are positive Recognized Earnings to allocate.

Priority 6: Allocate to the Contingency Reserve an amount equal to 1% of the Market Value of Assets as of the Valuation Date to the extent there are positive Recognized Earnings to allocate.

Priority 7: Allocate to the Employer Reserve an amount, if necessary, when combined with other Valuation Reserves, to provide 100% funding of the AAL as of the Valuation Date to reach the Funding Goal. In the event there are negative Recognized Earnings, allocate the entire amount.

Priority 8: The Board may consider additional actions as permitted under the County Employee Retirement Law (CERL) using funds in excess of the amount needed to meet the Funding Goal for ~~adjustments to the employer's contributions and/or~~ funding ~~for~~ discretionary benefits. "Excess Earnings" as defined in the County Employees Retirement Law (CERL) may be appropriated upon reaching the Funding Goal, however, the Board may consider adjustment to the employer's contributions only upon satisfying California Government Code Section 7522.52(b).

Increases to the Employer Reserve and the Advanced Employer Contributions Reserve amounts will be allocated first to cover the expected Normal Cost payment for the valuation year and then proportionally to each Yearly UAAL amount. All UAAL layers are assumed to be fully amortized once the plan equals or exceeds a 100% Funded Ratio.

If the Funding Goal has been met and previously unallocated Excess Earning are used for discretionary benefits under Priority 6, the actuarial assumed earnings rate will need to be assessed as part of the next scheduled investigation study regarding the projected net earnings available to fund future benefits.

3. Valuation Cycle

Annually, LACERA shall engage the services of an actuary to conduct a valuation of plan liabilities and assets to measure the funding progress of the plan. Every third year the actuary shall conduct an investigation of experience to measure the effectiveness of the plan assumptions and valuation methodology and make recommendations to the Board as needed. While the plan document provides for the valuations to be conducted not less than every three years, the funding policy will require an annual valuation and a recommendation of employer rates on an annual basis. Employee rates will be recommended as required due to changes in the underlying assumptions and methodology used to calculate the employee rates.

Notes:

2009: For the purposes of conducting the June, 30, 2009 actuarial valuation, the Board determined the STAR Reserve, as referenced in policy section II.2.(e), shall be a Valuation Reserve. As such, the actuary will include the STAR Reserve as part of the actuarial assets available for funding retirement benefits. Excerpt from Board of Investment minutes, December 9, 2009:

> A motion was made by Mr. Saladino, seconded by Chair Pryor to adopt the funding policy actuarial valuation effective June 30, 2009 as proposed in the Proposed Policy dated November 18, 2009, except to (i) include the STAR COLA Reserve in the valuation assets for the fiscal year ending June 30, 2009, and (ii) reevaluate the STAR COLA Reserve issue for the fiscal year ending June 30, 2010. The motion carried with Messrs. Hudson, Saladino, Scheider, Unger and Chair Pryor voting yes and Ms. Sandoval and Messrs. Barger and Russin voting no. Absent: Santos.

2010: For the purposes of conducting the June, 30, 2010 actuarial valuation, the Board determined the STAR Reserve, as referenced in policy section II.2.(e), shall be a Valuation Reserve. As such, the actuary will include the STAR Reserve as part of the actuarial assets available for funding retirement benefits. Excerpt from Board of Investment minutes, November 10, 2010:

> A motion was made by Mr. Saladino, seconded by Chair Santos that the non-vested portion of the STAR COLA Reserve be included as a valuation asset for one year and that the Board of Investments revisit the issue prior to next year's asset valuation. The motion carried with Messrs. Pryor, Russin, Saladino, Valenzuela, and Chair Santos voting yes and Ms. Sandoval and Messrs. Barger and Schneider voting no. Absent: Unger.

2011: For the purposes of conducting the June 30, 2011 actuarial valuation, the Board determined the STAR Reserve, as referenced in policy section II.2(e), shall be a Valuation Reserve. As such the actuary will include the STAR Reserve as part of the actuarial assets available for funding retirement benefits. Excerpt from Board of Investment minutes, October 12, 2011:

> A motion was made by Mr. Pryor, seconded by Mr. Santos to include the STAR COLA Reserve as a valuation asset for fiscal year 2011 and direct staff to provide information at the next Board meeting, on modifying the Funding Policy with respect to the STAR COLA Reserve and on securing an indemnification from the County with respect to that Reserve for fiscal year

2012 and beyond, to allow the Reserve to be included as a valuation asset. The motion carried with Messrs. Valenzuela, Pryor, Kelly, Santos and Unger voting yes and Messrs, Schneider, Russin, Ms. Sandoval and Chair Barger voting no.

November 2, 2010

TO: Each Member
Board of Investment

From: Robert Van Der Volgen Jr.
Chief Counsel

For: November 10, 2010 Board of Investments Meeting

Subject: **STAR Cola Reserve**

Today you are being asked to decide whether to include the STAR Cola Reserve as a plan valuation asset for purposes of LACERA's funding policy. Last year this Board adopted a funding policy that included the STAR Cola Reserve as a plan valuation asset for the fiscal year ending June 30, 2009. The same motion adopting this policy also required that this Board, "reevaluate the STAR Cola Reserve issue for the fiscal year ending June 30, 2010." The discussion and debate concerning this motion included consideration of our opinion that the terms of the 2002 Retirement Benefit Enhancement Agreement between the County and LACERA limited the use of the STAR Cola as a plan valuation asset.

We have prepared this memorandum in anticipation that you may have questions concerning our opinion as to the discretion you have relative to the valuation of the STAR Cola reserve in your funding policy for the fiscal year ending June 30, 2010. We have also included below questions that may merit your review as you deliberate the funding policy.

As a threshold matter, the termination of the 2002 agreement negates further consider of the specific provision relating to treatment of the STAR Cola Reserve for the fiscal year ending June 30, 2009. We therefore turn to the more general matters we believe your Board should consider in addressing this current funding policy.

Under Article XVI, section 17 of the California Constitution, sole and exclusive authority for administering LACERA rests with its boards. Among this authority is the, "power to provide for actuarial services in order to assure the competency of the assets of the public pension or retirement system." "As long as an actuarial method is 'reasonable' and not 'arbitrary' or 'irrational,' it may be applied even though other approaches may be equally correct or even "more precise' or 'better.'" *88 Ops.Cal.Atty.Gen. 1, 7* (2005). The purpose and intent section of Proposition 162 noted that one of the purposes of amending the state constitution was, "To ensure that all actuarial determinations necessary to safeguard the competency of public pension funds are made under the sole and exclusive direction of the responsible retirement boards."

As we discussed at your Board meeting December last, the exercise of your discretion over the funding policy and the actuarial evaluation is subject to your fiduciary duties as trustees of the LACERA. Your two primary duties are the duty of loyalty and duty of prudence.

Your duty of loyalty is found in subdivision (b) of Article XVI, section 17, which states, "The members of a retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty." The intent language of Proposition 162 affirmed this duty by stating one of the purposes of adopting The California Pension Protection Act of 1992 was, "To affirm the legal principle that a retirement board's duty to its participants and their beneficiaries takes precedence over any other duty." We note, however, that your constitutional duties also include "minimizing employer contributions."

Your duty of prudence in found in subdivision (c) of Article XVI, section 17, which states, "The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person, acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of like character and with like aims." This duty is often compared to the duty of prudence applicable to trustees of ERISA plans. ERISA fiduciaries must discharge their duties with adequate expertise. ERISA fiduciaries have an obligation to not only use their own special skills and expertise, but to also to engage qualified advisers and managers if they lack the expertise themselves.

With this backdrop, we recommend your deliberations examine such questions as[1]:

1. The potential need for using the STAR Cola reserve to pay STAR Cola benefits.
2. What mechanism, if any, is available to cover any gap in the UAAL as a result of paying STAR Cola benefits?
3. What are current funding trends?
4. What are current financial accounting trends?
5. What is the impact upon the active and retired plan beneficiaries?
6. What other funding may be available?
7. What are the views of your actuary?

While we lack the expertise to address these questions, we believe that an adequate record that reflects your consideration of these and other factors that may present themselves in the course of your deliberations will minimize the risk of a successful challenge. We note that challenges to retirement board decisions concerning funding, when brought by plan beneficiaries, are generally not successful. This is especially true when the decision reflects reasonable exercise of the board's fiduciary duties with consideration of the overall best interests of all LACERA members.

RV:dd

[1] This is not intended as a definitive list of questions. We recognize that during the course of your deliberations you may find it unnecessary to address particular questions on this list.

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WILLIAM T FUJIOKA
Chief Executive Officer

February 7, 2013

Mr. Gregg Rademacher
Chief Executive Officer
Los Angeles County Employees Retirement Association
300 N. Lake Avenue
Pasadena, CA 91101-4199

Dear Mr. Rademacher:

STAR COLA RESERVE

We understand that the Los Angeles County Employees Retirement Association's (LACERA) Board of Investments will discuss the Supplemental Targeted Adjustment for Retirees Cost of Living Adjustment (STAR COLA) reserve at its meeting on February 13, 2013. We ask that the Board of Investments consider continuing the practice of the last ten years of including the STAR COLA reserve as part of the valuation assets. Further, the County requests that the funding policy be modified with respect to the inclusion of the STAR COLA. The County is willing to indemnify LACERA as it did in the 2002 funding agreement.

Since 2002, the Board of Investments has included STAR COLA reserves with other valuation assets to determine the funded status of the retirement system. This was part of the funding agreement adopted in 2002. Since 2009, it has been approved on an annual basis at the request of the County. In prior requests, the County cited the economic downturn and the need to minimize employer costs during that extremely difficult time. We also noted the following:

- Continuing to count STAR COLA reserves as valuation assets will not jeopardize the STAR COLA program, the long-term financial security of the retirement system, or the system's ability to pay benefits to LACERA members as they become due.

- Failure to continue current policy would have significant fiscal consequences. As with the investment return assumption, a change in policy would impact resources needed for jobs.

- LACERA has the legal latitude to continue this policy as it sees fit.

The County again requests that the STAR COLA reserves be included for the purpose of determining the funding status of the retirement system. We would request that this be written into the funding policy as it was in 2002 with an indemnification of LACERA by the County. While we recover from our fiscal crisis, it is still important to the County to avoid the approximately $31 million in additional Unfunded Actuarial Accrued Liability (UAAL) charges. In addition, the reasoning cited in the three bullets above remains.

We would like thank you for the assistance you have provided to Chief Executive Office staff. LACERA and the County have a unique partnership and we value our positive working relationship. Should you have any questions regarding this matter, please contact either me or Maryanne Keehn of this office at (213) 974-0470.

Respectfully submitted,

WILLIAM T FUJIOKA
Chief Executive Officer

WTF:BC:JA
MTK:mst

c: Each Supervisor
Wendy L. Watanabe, Auditor-Controller
John F. Krattli, County Counsel
SEIU Local 721
Coalition of County Unions

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California Constitution

ARTICLE 16: PUBLIC FINANCE

Section 17

The State shall not in any manner loan its credit, nor shall it subscribe to, or be interested in the stock of any company, association, or corporation, except that the State and each political subdivision, district, municipality, and public agency thereof is hereby authorized to acquire and hold shares of the capital stock of any mutual water company or corporation when the stock is so acquired or held for the purpose of furnishing a supply of water for public, municipal or governmental purposes; and the holding of the stock shall entitle the holder thereof to all of the rights, powers and privileges, and shall subject the holder to the obligations and liabilities conferred or imposed by law upon other holders of stock in the mutual water company or corporation in which the stock is so held.

Notwithstanding any other provisions of law or this Constitution to the contrary, the retirement board of a public pension or retirement system shall have plenary authority and fiduciary responsibility for investment of moneys and administration of the system, subject to all of the following:

(a) The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.

(b) **The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty**. (emphasis added)

(c) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.

(d) The members of the retirement board of a public pension or retirement system shall diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so.

(e) The retirement board of a public pension or retirement system, consistent with the exclusive fiduciary responsibilities vested in it, shall have the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets of the public pension or retirement system.

(f) With regard to the retirement board of a public pension or retirement system which includes in its composition elected employee members, the number, terms, and method of selection or removal of members of the retirement board which were required by law or otherwise in effect on July 1, 1991, shall not be changed, amended, or modified by the Legislature unless the change, amendment, or modification enacted by the Legislature is ratified by a majority vote of the electors of the jurisdiction in which the participants of the system are or were, prior to retirement, employed.

(g) The Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board pursuant to this section.

(h) As used in this section, the term "retirement board" shall mean the board of administration, board of trustees, board of directors, or other governing body or board of a public employees' pension or retirement system; provided, however, that the term "retirement board" shall not be interpreted to mean or include a governing body or board created after July 1, 1991 which does not administer pension or retirement benefits, or the elected legislative body of a jurisdiction which employs participants in a public employees' pension or retirement system.

California Public Employee Pension Reform Act of 2013

§ 7522.52 Employer Contribution; Suspension

(a) In any fiscal year, a public employer's contribution to a defined benefit plan, in combination with employee contributions to that defined benefit plan, shall not be less than the normal cost rate, as defined in Section 7522.30, for that defined benefit plan for that fiscal year.

(b) The board of a public retirement system may suspend contributions when all of the following apply:

(1) The plan is funded by more than 120 percent, based on a computation by the retirement system actuary in accordance with the Governmental Accounting Standards Board requirements that is included in the annual valuation.

(2) The retirement system actuary, based on the annual valuation, determines that continuing to accrue excess earnings could result in disqualification of the plan's tax-exempt status under the provisions of the federal Internal Revenue Code.

(3) The board determines that the receipt of any additional contributions required under this section would conflict with its fiduciary responsibility set forth in Section 17 of Article XVI of the California Constitution.

(Added by Stats. 2012, Ch. 296, [AB340]