Overview and Initial Issues Identification
Seattle City Employees' Retirement System (SCERS)

Staff: John McCoy
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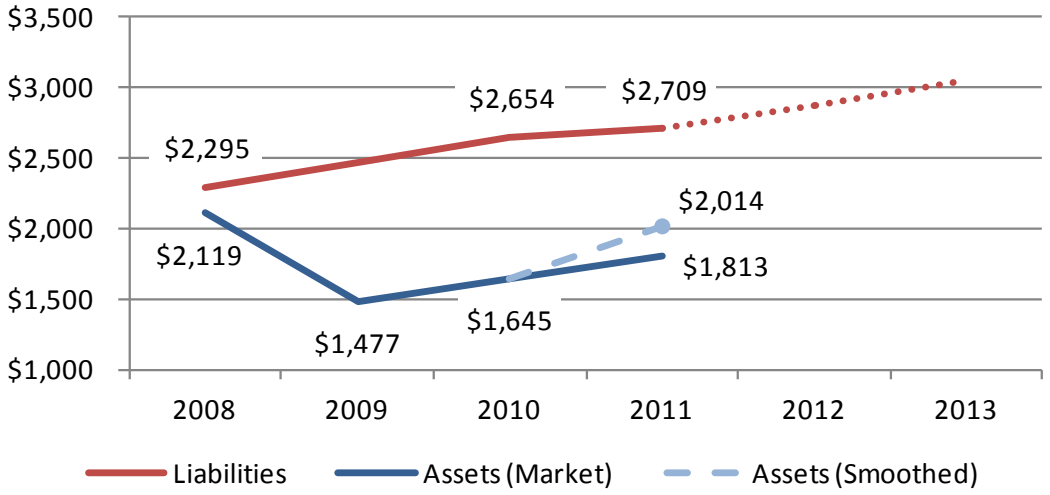
Introduction / Financial Update:

The Seattle City Employees' Retirement System (SCERS) is a defined-benefit pension that provides income in retirement for non-uniformed City employees. The system currently has about 10,600 active and vested members, and about 5,400 retirees and surviving spouses receiving benefits. Employee and City contributions into SCERS are invested by the Board of Administration in a variety of stock, bond, real estate and other instruments to earn a return and support benefit payments for current and future retirees. Defined benefit pension systems that pre-fund and invest their contributions generate a substantial share of the total cost of the benefit through investment income. SCERS currently assumes that its investments will earn a long-run average annual return of 7.75%, net of fees. Over the past 30 years, SCERS has exceeded this target. Over the past 10 years, it has not, and the future remains uncertain.

Figure 1 – SCERS Assets and Liabilities
$s in millions, Actuarial Present Value as of January 1 each year



SOURCES: 2008 Valuation, 2010 Valuation, 2010 Annual Report, 2011 Valuation, Central Staff Projections

SCERS had assets equal to 92.4% of its required funding on January 1, 2008, according to actuarial estimates. A funding ratio of 80% or higher that is also stable or improving is considered generally safe by pension experts. Like many pension systems, the SCERS investment portfolio lost a significant share (26.8%) of its value in the market crises of 2008, an event which continues to have significant repercussions. Relative to the expected return, the 2008 event put SCERS almost 35% behind its projected funding path. Even with stronger returns in 2009 (10.8%) and 2010 (13.2%), this loss is nearly impossible to make up through investment performance alone. Indeed, it would take an average annual return of 16.4% for five years to make up the lost ground, or an annual return of 12.0% over 10 years. Such performance is well outside the reasonable range that SCERS' actuaries and investment consultants use for their estimates. Given strong legal restrictions on benefit cuts for current members, this leaves additional contributions as the only way to put SCERS back on a path toward full funding.

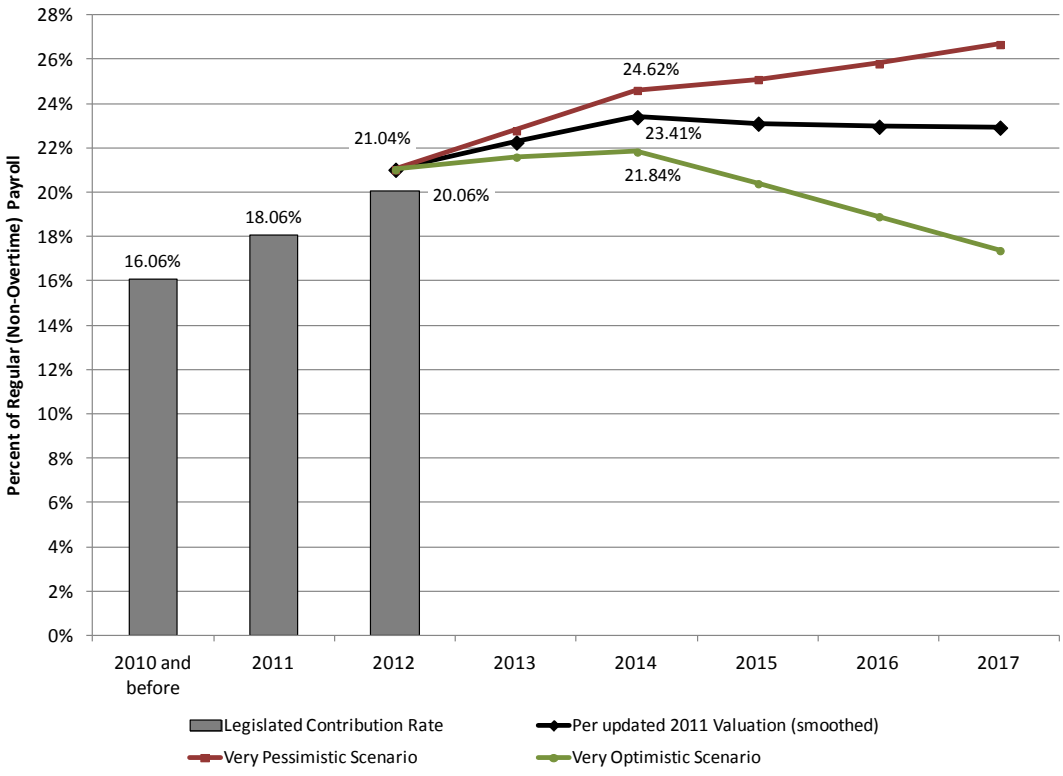
Table 1 – Recent Contribution Rate History
% of regular (non-overtime) payroll

	Employee Contribution	City Contribution	Combined
2010 and prior	8.03%	8.03%	16.06%
2011	9.03%	9.03%	18.06%
2012 Legislated / Endorsed	10.03%	10.03%	20.06%
2012 Proposed		11.27%	21.30%
2012 October Update		11.01%	21.04%

In late 2009, the City negotiated with its labor unions to increase employee contributions by up to 2% of payroll if the next actuarial report showed SCERS' unfunded liabilities could not be paid off (amortized) within 30 years, a common funding goal. The SCERS actuary concluded in 2010 the liabilities would, in fact, *never* get paid off at the old rate. Consequently, the City Council legislated a rate increase to 10.03% over two years, bringing the combined rate to 20.06% for 2012. This only partially met the required contribution level, estimated that year at 25.03%, and further increases appeared necessary.

In 2011, the SCERS Board of Administration conducted an experience study examining the data and assumptions used to estimate the pension fund's liabilities. Assumption changes made in that study had the effect of reducing liability estimates somewhat. In addition, the Board adopted a smoothing policy in which the effects of investment performance are phased in over five years. Smoothing is intended to prevent market volatility from causing abrupt shifts in required contribution rates. The SCERS actuary concluded that a 5-year smoothing period, which is the most common practice for public pensions, was reasonable and struck a balance between mitigating volatility and quickly recognizing true and permanent changes in the asset value. Smoothing also has the benefit of providing a gradual, multi-year contribution path, which facilitates budget planning and is transparent to outside reviewers (such as rating agencies).

Figure 2 – Projected Total Contribution Rate Path, 2012-2017



Required contributions are projected to increase through 2014 to 23.41%, as the investment losses suffered in 2008 are fully smoothed in. The contribution level, once raised, is likely to remain elevated indefinitely, as the rate is designed to pay off SCERS' unfunded liabilities over 30 years. There are also several significant risks and uncertainties around the projected rate path:

- The rate will depend on future ***investment returns***. Performance above 7.75% will tend to lower the future contribution rate, while returns under that level will tend to increase it. With smoothing, these variances will be phased in over five years. As shown in the "Very Optimistic" scenario, even superlatively strong investment returns are unlikely to prevent the need for further increases in the 2013-2014 biennium.

- The rate – calculated as a percentage of payroll – assumes significant ***payroll growth*** in future years including inflation, wage increases, and population growth. These assumptions are consistent with SCERS' long-run experience, but to the extent that payroll growth is lower in the future, the rate will need to be higher.

The last piece of the pension puzzle is the interest rate that SCERS pays on employee contributions. In October 2011, the SCERS Board revisited the interest rate, currently 5.75% (compounded annually). This interest is reflected in the accumulated contribution balance that members see on their annual statements. Members who leave City service before retirement have the option of withdrawing their contributions (but not the City's) with interest. Typically, they would roll over the proceeds into another retirement fund. Given recent interest rates, currently at historical lows, the SCERS Board chose to peg the 2012 interest rate to the yields on 30-year U.S. Treasury Bonds, plus 0.25%. For 2012, this results in a rate of 4.47%. This change lowered SCERS' estimated liabilities and lowered the required contribution rate by 0.26% of payroll for 2012.

Identified Issues:

Several interlocking Council actions will be proposed to address retirement contributions in 2012 and beyond. These include:

1) Funding Policy Resolution – Greensheet #1

The proposed resolution would re-affirm the City's commitment to fully fund its pension system and also provide clarity on the approach and timeframes to be used. The Seattle Municipal Code (SMC) states that the City will match the employees' pension contributions, and, in addition, will fund whatever actuarially required contributions are necessary to guarantee benefits. However, the code is not specific in defining actuarial methods or timeframes for compliance, and pension policy changes are often implemented gradually, given the long time horizons involved.

In 2010, the City legislated increases for both employee and employer contributions through 2012 and declared its intent to raise City contributions still higher to meet the actuarial requirements. This temporarily left a gap between the 20.06% legislated rate and the ultimate 25.03% level of required contributions (as of the 1/1/2010 valuation). The City's rating agencies all cited this gap as a sign of financial stress on the City in reviewing our 2011 debt issuance, and Standard & Poor's put Seattle on a negative watch. Bond buyers, on the other hand, continued to bid aggressively for Seattle's debt, and the 2011 issuance was completed at an interest rate of 3.65%, well below planning assumptions.

Coupled with the increased pension contributions in the 2012 Proposed Budget, it is hoped that the resolution will provide reassurance to the bond markets that Seattle is willing and able to put SCERS

back on a path toward full funding. The resolution would endorse recent policy changes enacted by the SCERS Board of Administration to adjust actuarial assumptions and implement 5-year asset smoothing.

Table 2 – Employer contributions to SCERS
Per current policy and per updated, smoothed 2011 projections

	Current Policy			2011 Projection		
Year	Covered Payroll (estimated)	Employer Contribution Rate	Employer Contribution $ (All funds)	Employer Contribution Rate	Employer Contribution $ (All funds)	Difference (All funds)
2012	$ 558,500,000	10.03%	$ 56,017,550	11.01%	$ 61,490,850	$ 5,473,300
2013	$ 586,425,000	10.03%	$ 58,818,428	12.24%	$ 71,778,420	$ 12,959,993
2014	$ 615,746,250	10.03%	$ 61,759,349	13.38%	$ 82,386,848	$ 20,627,499
2015	$ 646,533,563	10.03%	$ 64,847,316	13.09%	$ 84,631,243	$ 19,783,927
2016	$ 678,860,241	10.03%	$ 68,089,682	12.95%	$ 87,912,401	$ 19,822,719
2017	$ 712,803,253	10.03%	$ 71,494,166	12.91%	$ 92,022,900	$ 20,528,734

Note: Table assumes payroll growth of 5%, consistent with actuarial assumptions. City Budget Office planning estimates for these years may vary.

The resolution has significant financial implications. In 2014, the City (including the utilities) would contribute $20.6 million more per year to the pension system annually, relative to currently legislated rates. As previously discussed, this assumption will vary with investment performance going forward. It may be higher if the SCERS portfolio fails to earn its 7.75% expected return and lower if it exceeds the return.

2) Interest Rate Resolution – Greensheet #2

As discussed above, the SCERS Board of Administration voted on October 5 to pay 4.47% interest on new contributions in 2012. Per the SMC, this action is subject to Council approval, which the proposed resolution would provide.

The Board's policy would continue to credit all contributions received before the end of 2011 with 5.75% interest. Going forward, the SCERS Board opted to peg the interest rate to other rates found in the marketplace, specifically 30-year U.S. Treasury bonds, which are at historic lows, plus 0.25%. The Board also adopted an upside cap of 5.75%. Finally, the Board declared its intent to review and adjust the rate annually. It is expected that future adjustments will be ready in the summer, before the Council phase of the budget.

The interest rate change has the effect of lowering SCERS' liabilities, reducing the required total contribution rate by 0.26% of covered payroll in 2012. These savings are expected to grow over time as future contributions are subject to the lower interest rate. Despite these savings, required contributions are still expected to exceed the currently legislated 20.06% levels for the foreseeable future.

3) Employer Contribution Adjustment – Greensheet #3

The Proposed 2012 Budget includes appropriations to support an 11.27% employer contribution, at an incremental cost of nearly $7 million citywide, including the utilities, relative to the 2012 Endorsed rate of 10.03%.

Following the interest rate vote, the required employer contribution for 2012 would be 11.01%. A greensheet during the Council phase would make the Citywide adjustment. The incremental savings are currently estimated at $1.4 million across all funds, including the utilities. Of this, approximately $600,000 accrues to the General Subfund.

Other Issues – Retirement Benefit Redesign Update and 2011 SLI Response:

The Council passed a Statement of Legislative Intent (SLI) with the 2011 Budget calling for the creation of an interdepartmental team (IDT) to study changes to the retirement system for new hires. The goal is to lower costs and make the pension system more sustainable for employees and the City. The Council also added $250,000 to the budget for consultant resources to support this effort. The IDT report is due on February 15, 2012. To date, the IDT can report the following progress:

- The Legislative Department hired the actuarial firm Gabriel, Roeder, Smith & Co. to model the IDT's proposed pension changes and provide research and expert guidance for the effort. The consultant has assisted numerous jurisdictions through pension changes, including recently the Cities of Austin, Texas and Denver, Colorado, and the State of Utah.

- The IDT has compiled significant research on comparative pension policy, recent changes made by other public employers, and income replacement goals for retirees.

- The IDT and the consultant have begun to map out alternative pension policies. GRS has received and calibrated Seattle's pension data and will soon deliver an interactive Excel model for City staff use that will show the costs and benefits of each candidate plan. At this point, it appears very possible to achieve significant cost savings for employees and the City with modest impacts on retirement income and retirement timing for new hires.

- The IDT has begun the process of briefing and consulting with key stakeholders, including the city's labor unions, the SCERS Board of Administration, and retirees (Association of Retired Seattle City Employees). The IDT has worked in concert with the Personnel Department and labor relations. Further stakeholder collaboration is expected as the consultant's work progresses.