FINAL

From: John McCoy July 27, 2012
Council Central Staff

To: Tim Burgess, Chair, Government Performance & Finance Committee
Nick Licata, Vice Chair
Sally J. Clark, Member

Re: Impact of SCERS' 2012 Actuarial Valuation on Upcoming City Budgets

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Council Central staff have had the opportunity to review Milliman actuaries' 2012 Valuation report for the Seattle City Employees' Retirement System (SCERS). The new valuation will have a significant impact on City budgets in the 2013-2014 biennium and beyond.

SCERS is Seattle's defined benefit pension plan for most City employees. Employees and the City make contributions into the Retirement Fund each pay period to pre-fund the retirement benefits that are earned with their service. SCERS invests these contributions in a portfolio of stocks, bonds, real estate funds, etc. In pre-funded retirement plans, contributions provide about 1/3rd of the money needed to pay benefits. Returns on the investments are expected to provide the remaining 2/3rds.

2011 Investment Performance

The SCERS portfolio ended the year valued at $1.75 billion. Volatile markets in 2011 were dominated by worries over the European debt crisis and the future of the Eurozone, which pushed stock prices sharply lower in the second half of the year. SCERS, like most every other public pension fund, missed its 7.75% investment return target, posting a 0% return. This return statistic was calculated *before* posting a negative $12.9 million reserve against expected investment losses, and further write-downs are possible in future years. SCERS' performance also trailed the median public pension fund,[1] which posted a positive 0.7% return in 2011. This continues a trend of the Retirement Fund underperforming relative to its peers.

Table 1 – SCERS Portfolio Performance vs. the Median Public Fund, at 2011 Year End

	Annualized Return			
	1 Year	**3 Year**	**5 Year**	**10 Year**
SCERS Portfolio	-0.0%	7.7%	-0.3%	4.4%
Median Fund	0.7%	11.1%	2.0%	5.7%
Difference	*-0.7%*	*-3.4%*	*-2.3%*	*-1.3%*

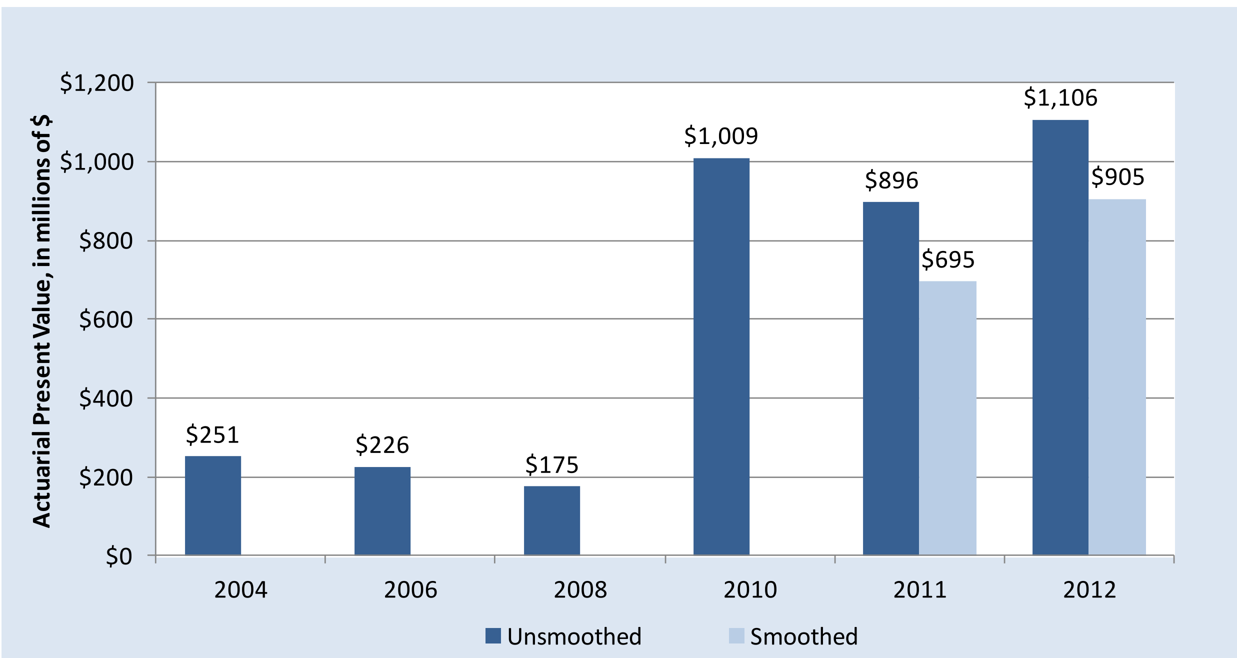
SOURCE: Pension Consulting Alliance 4th Quarter 2011 Monitoring Report

[1] Median Fund is the Mellon Total Public Funds Universe greater than $1 Billion, as provided by Pension Consulting Alliance.

Actuarial Impact

In actuarial terms, the system's assets lost $210 million worth of ground relative to its liabilities in 2011. Unfunded liabilities for promised pension benefits now stand at $1.1 billion on a market value basis ($905 million using five-year asset smoothing[2]). This essentially means that the Retirement Fund should have an additional $1.1 billion on hand today in order to be fully funded over the long term. The unfunded portion represents an unprecedented 199% of covered payroll (162% with smoothing). The system's funded ratio – which represents the percentage of liabilities that are covered by assets – is 61% on a market value basis (68% with smoothing).

Figure 1 – Recent History of SCERS' Unfunded Liabilities, 2004-2012 (in millions)
Values shown as of January 1 of each year



SOURCE: 2012 Valuation Report, Milliman

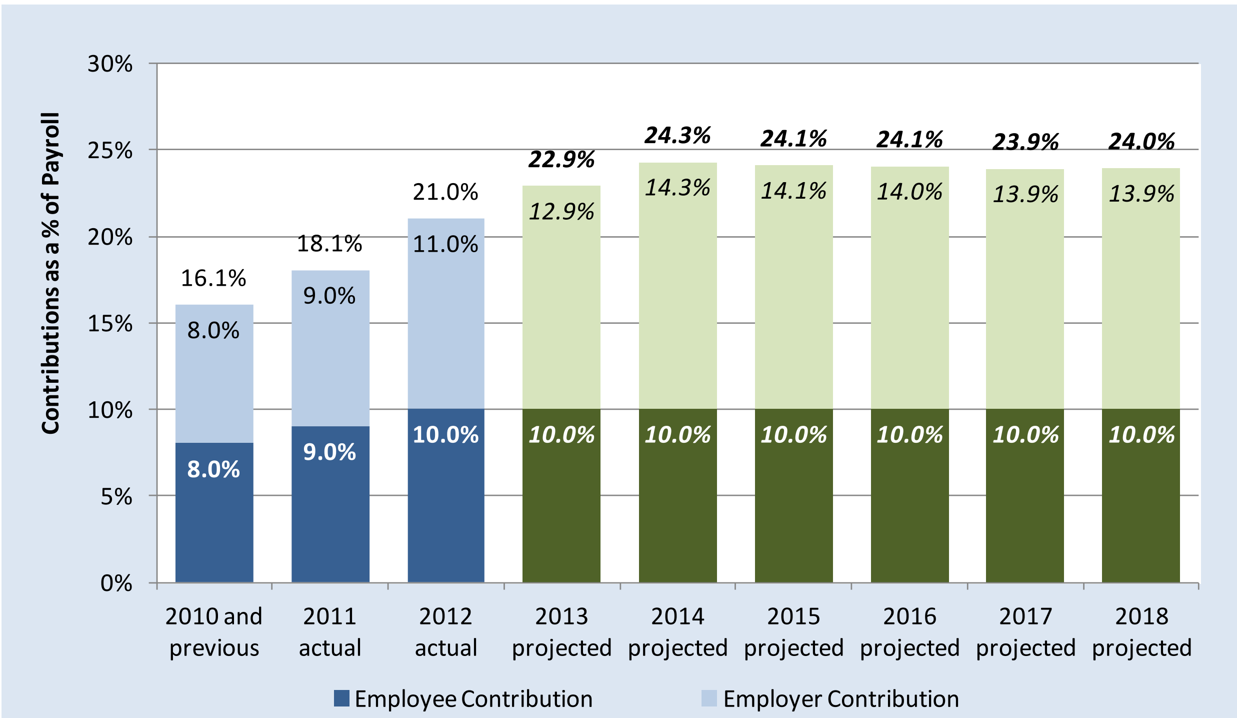
Effect on City Contribution Rates

In 2011, the City adopted Resolution 31334, pledging to fully fund the required contributions as determined by the SCERS actuary each year, and this pledge helped the City maintain its AAA bond rating. The policy set the City on a multi-year path of contribution rate increases that were previously estimated to settle around 23% of payroll. The 2012 Valuation generally added about 1% of payroll to this path, and contributions are now expected to settle around 24%. For reference, each 1% of payroll is about $5.6 million dollars per year. Major causes of this increase include:

[2] Since investment returns can be volatile from year to year, most public pension plans smooth their investment performance over five years or more to mitigate large swings in the required contribution amounts.

- Poor 2011 investment returns on the SCERS portfolio,
- A data revision correcting an error that caused the 2011 Valuation to understate liabilities by over $30 million, and
- A shrinking City payroll, which provides a smaller base on which to pay off the system's unfunded liabilities.

Figure 2 – Projected Contribution Rates as a % of Covered Payroll



SOURCE: 2012 Valuation Report, Milliman

City Budget Implications

The contribution rate increases will impact budgets in all City departments. For each employee, the City's cost of providing a pension benefit is projected to rise by 78%, from 8.0% of payroll in 2010 to 14.3% by 2014. At current covered payroll levels, this 6.3% percentage point increase will cost the City about $35 million per year. These are funds that will not be available for City services, hiring new workers, COLAs, or other benefits.

Table 2 – Projected City Contributions into SCERS, 2010-2018 (in millions)

Paying Dept.	2010	2011	2012	2013	2014	2015	2016	2017	2018
General Government	$ 26.1	$ 29.3	$ 35.7	$ 43.9	$ 51.0	$ 52.9	$ 55.3	$ 57.4	$ 60.4
Seattle City Light	$ 10.4	$ 11.6	$ 14.1	$ 17.4	$ 20.2	$ 21.0	$ 21.9	$ 22.8	$ 24.0
Seattle Public Utilities	$ 7.8	$ 8.7	$ 10.6	$ 13.1	$ 15.2	$ 15.8	$ 16.5	$ 17.1	$ 18.0
Total	$ 44.3	$ 49.7	$ 60.5	$ 74.3	$ 86.5	$ 89.6	$ 93.7	$ 97.4	$ 102.4
% Increase from 2010		*12%*	*36%*	*68%*	*95%*	*102%*	*112%*	*120%*	*131%*

Note: Values are approximate and calculated from the actuarial report's covered payroll series, contribution rates, and long-run payroll growth assumptions. They will differ from the City Budget Office's short-term projections for the same years.

Future Risks to the Contribution rate

There are significant risks that required contribution rates could be forced even higher.

- **Investment Returns** – The contribution rate path assumes that the SCERS investment portfolio grows by 7.75% per year. The Fund has fallen far short of this target for the past decade, though it has exceeded the target over 30 years. Retirement systems across the country have been re-examining their return assumptions, and many are reducing them. Any reduction in expected investment returns would drive required contributions higher.

- **Payroll Growth** – Milliman's long-run assumptions envision that the City will experience significant growth in wages and City employment. While these assumptions are generally consistent with the City's long-run experience, they may not continue in the future. Slower future growth would drive pension contribution rates higher in order to pay off the system's unfunded liabilities on a smaller payroll base.

Future Directions for City Policy

Resolution 31334, which set City contribution policy for SCERS, endorsed specific actuarial methods and assumptions, which included paying off the unfunded liabilities within 30 or fewer years. As the City has gained experience with this policy, it has become clear that there are several ways to implement this 30-year funding approach, with very different implications for the City's costs and funding progress in the Retirement Fund. The City and the Retirement Board may wish to further calibrate the policy in the 2013 actuarial valuation.