ACTUARIAL FUNDING POLICY

BOARD OF INVESTMENTS
ADOPTED: OCTOBER 2024

Actuarial Funding Policy

Authorizing Manager: Jonathan Grabel, Chief Investments Officer

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Mandatory Review: July 1, 2027 (Every 3 Years)

Approval Level: Board of Investments

I. Purpose

The policy provides guidance to the Board of Investments (BOI) in making decisions about the funding of LACERA's retirement benefits. The policy also gives direction to LACERA's consulting actuary in their work.

II. Scope

The policy is applicable to the Board of Investments and is limited to the funding of LACERA's retirement benefits.

III. Legal Authority

The BOI governs LACERA in accordance with the California Constitution, County Employees Retirement Law (CERL), California Public Employees' Pension Reform Act of 2013 (PEPRA), Internal Revenue Code requirements, and applicable case law.

IV. Definitions

For the purpose of this Policy, the terms below have the following definitions:

Actuarial Accrued Liability (AAL) – The portion of the present value of projected benefits that is attributed to past service determined by the actuarial funding method.

Actuarial Cost Method – A process used to allocate present value of projected benefits among past and future periods of service.

Actuarial Standards of Practice – Guidance provided to actuaries on the techniques, applications, procedures, and methods that reflect appropriate actuarial practices in the United States.

Actuarial Surplus – The positive difference, if any, between the Valuation Assets and the Actuarial Accrued Liability

Actuarial Value of Assets (AVA) – The Fair Value of Assets less or plus the net deferred investment gains or losses not yet recognized by the Asset Smoothing Method.

IV. Definitions (Continued)

Asset Smoothing Method – A process used to spread the recognition of actuarial investment gains or losses (relative to the assumed return) over a period of time for the purposes of determining the Actuarial Value of Assets.

California Actuarial Advisory Panel – Group of eight appointed actuaries who provide public agencies with impartial and independent information on pensions, other post-employment benefits, and best practices, and report those recommendations to the Legislature.

California Public Employees' Pension Reform Act of 2013 (PEPRA or CalPEPRA) – This law affects retirement benefits and member contribution rates for most employees hired January 1, 2013, and later. Additional provisions put limitations on employer contribution rates.

County Employees Retirement Law of 1937 (CERL) – Body of law enacted to govern retirement benefits for certain public employees.

Conference of Consulting Actuaries Public Plans Community – Group charged with advancing the sound actuarial and governance practice in the public sector retirement and employee benefits arenas.

Employer Normal Cost Rate – The portion of the Normal Cost Rate not funded by member contributions.

Entry Age Actuarial Cost Method – An Actuarial Cost Method designed to fund a member's total plan benefit over the course of their career. This method is designed to produce stable employer and member contributions in amounts that increase at the same rate as the members' payroll (i.e., level percentage of payroll).

Fair Value of Assets (FVA) – The Fiduciary Net Position Restricted for Pension Benefits as defined by the Government Accounting Standards Board.

Legacy Plan Members – Members who are not in a PEPRA Plan.

Negative Amortization – When the annual contribution to pay down the UAAL is less than the annual increase in UAAL due to interest. In other words, negative amortization means the amount owed is expected to increase during the year.

Non-Valuation Reserves – The non-valuation reserves that are set aside for obligations or contingencies and are excluded from the assets used in the funding valuation. These reserves include the STAR Reserve, the Contingency Reserve, and the County Contribution Credit Reserve.

Normal Cost – The portion of the present value of projected benefits that is attributed to current service by the actuarial funding method.

Normal Cost Rate – The Normal Cost expressed as a percentage of salary.

PEPRA – California Public Employees' Pension Reform Act of 2013. This law affects retirement benefits and member contribution rates for most employees hired January 1, 2013 and later.

IV. Definitions (Continued)

PEPRA Plan Members – Members whose retirement benefit provisions are covered by PEPRA. For LACERA, this is General Plan G and Safety Plan C.

Realized Earnings – Earnings that have been received. This excludes changes in asset values due to appreciation/depreciation.

Statutory Benefits – LACERA benefits provided under CERL and PEPRA. For purposes of this Funding Policy, Statutory Benefits do not include Other Post-Employment Benefits such as retiree healthcare benefits.

Unfunded Actuarial Accrued Liability (UAAL) – The portion of the Actuarial Accrued Liability that is not currently covered by Valuation Assets. It is calculated by subtracting the Valuation Assets from the Actuarial Accrued Liability.

Valuation Assets – The value of assets used in the actuarial valuation to determine employer contribution rate requirements. It is equal to the Actuarial Value of Assets reduced by the value of any Non-Valuation Reserves.

V. Policy

A. Funding Policy Principles

1. **Mission:** LACERA's mission is to produce, protect, and provide the promised benefits to its members. The Board of Retirement (BOR) is responsible for the administration of the retirement system. The Board of Investments (BOI) is responsible for establishing LACERA's investment policy and objectives, as well as exercising authority and control over the investment management of the pension and benefits trusts.

2. **Legal Authority:** The BOR and BOI govern LACERA in accordance with the California Constitution, County Employees Retirement Law (CERL), California Public Employees' Pension Reform Act of 2013 (PEPRA), Internal Revenue Code requirements, and applicable case law. Such laws provide the boards with authority to pay Statutory Benefits and fund these benefits in an actuarially sound manner, consistent with their fiduciary responsibilities of prudence and loyalty to members and beneficiaries under Article XVI, Section 17 of the California Constitution.

3. **Key Principles:** To assist the system in performing its tasks, LACERA engages the services of outside investment, actuarial, legal, and other professionals. Investment consultants are primarily guided by LACERA's Investment Policy. The Actuarial Funding Policy ("Funding Policy") provides guidance on LACERA's funding objectives.
    a. **Benefit Security and Risk Mitigation** – The primary principle guiding actuarial funding of LACERA is ensuring that the plan can timely pay Statutory Benefits to the system's members and beneficiaries and mitigate risk in that regard.

V. Policy (Continued)

b. **Employer Contribution Rate Stability** – Actuarial funding should be designed such that employer contributions will make up for any differences in actual assets from the Funding Goal within a defined and reasonable period of time while seeking to mitigate year-to-year volatility in employer contribution rates when prudent. Employer contribution rates should be minimized to the extent practicable while maintaining the actuarial soundness, diversified portfolio, and appropriate funding of LACERA, in accordance with Section 31454.7 of CERL and other applicable law.

c. **Intergenerational Equity** – To the extent practicable, actuarial funding should aim for intergenerational equity where each generation of taxpayers incurs the cost of benefits for the employees who provide services to those taxpayers.

d. **Sound and Transparent Process** – The BOI has authority and fiduciary responsibility with respect to actuarial funding. The Funding Policy provides additional transparency and guidance for the BOI in overseeing the actuarial funding process.

4. **Contribution Rate Guidance:** Actuarial funding aims for contributions of employers and active members to collectively accumulate to be equal to the present value of benefits for members by the time they retire. 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 BOI in determining employer and member contribution rates which aim to achieve the Funding Goal and satisfy the Funding Policy principles. Key terms used in this policy are defined in Section IV.

B. Funding Goal

1. **100% Funded Ratio:** LACERA's Funding Goal is to attain long-term full funding of LACERA's retirement benefits, such that the Funded Ratio is equal to 100% or greater (Valuation Assets at least equal to the Actuarial Accrued Liability). The Funding Goal is designed to assure the competency of LACERA assets to timely pay promised benefits in accordance with Article XVI, section 17 of the California Constitution, CERL, PEPRA and other applicable law.

2. **Progress:** Progress to the Funding Goal should be done through a reasonable and equitable allocation of the cost of benefits over time, while satisfying the key principles of the Funding Policy.

V. Policy (Continued)

C. Valuation Cycle

1. **Schedule:** LACERA engages the services of an actuary to conduct an annual valuation of plan liabilities and assets to measure the funding progress of the plan. Every third year the actuary conducts an investigation of experience to measure the effectiveness of the plan assumptions and valuation methodology and make recommendations to the BOI as needed. While the CERL provides for the valuations to be conducted not less than every three years, the Funding Policy requires a valuation and a recommendation of employer contribution rates and PEPRA member rates on an annual basis.

   Contribution rates for Legacy Plan Members will be recommended as required due to changes in the underlying assumptions and methodology used to calculate the member rates. The BOI shall set employer and member contribution rates based upon the investigation, valuation, and recommendations of the actuary, in accordance with CERL, PEPRA and other applicable law.

2. **Actuarial Audit:** Professional guidance indicates an actuarial audit should be performed at least once every five years. LACERA engages an independent actuarial firm to perform an actuarial audit every three years following the investigation of experience.

3. **Contribution Timing:** The contribution rates determined in each June 30th actuarial valuation are effective for the following fiscal year 12 months after the actuarial valuation date and in accordance with CERL.

D. Actuarial Funding Procedures

1. **Follows Guidance:** The actuarial funding procedures have been designed to comply with the Actuarial Standards of Practice and relevant guidance from the Conference of Consulting Actuaries Public Plans Community and the Government Finance Officers Association. Consideration should be given to guidance provided by the California Actuarial Advisory Panel (Government Code Section 7507.2).

2. **Actuarially Determined:** Annual funding is actuarially determined and is comprised of a payment of the Normal Cost, which is shared by the employers and members, and a payment on the Unfunded Actuarial Accrued Liability (UAAL), which is made by the employers. The Normal Cost Rate and the UAAL contribution rate are determined by the following three components of this policy:
   a. **Actuarial Cost Method:** The process used to allocate the total present value of future benefits to each year (Normal Cost), and all past years (Actuarial Accrued Liability);

V. Policy (Continued)

b. **Asset Smoothing Method:** The process used that spreads the recognition of actuarial investment gains or losses (relative to the assumed return) over a period of time for the purposes of determining the Actuarial Value of Assets used in the determination of the employer contribution rate; and

c. **Contribution Method:** The process to fund the Normal Cost and systematically pay off the Unfunded Actuarial Accrued Liability.

3. **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. The actuarial cost method should allocate the cost of paying for the promised benefits evenly over time, expressed as a percentage of payroll. An example of this would be the entry age actuarial cost method. Determining the cost as a percentage of payroll rather than level dollar promotes intergenerational equity as it reflects changing values over time due to inflation. The allocation of benefit financing to prior and future years is based on the Actuarial Cost Method, with the allocation for prior years being equal to the Actuarial Accrued Liability (AAL) and the allocation to the current year being equal to the Normal Cost. Note that the Actuarial Cost Method is an allocation of when to fund the benefits, not necessarily when they are being earned.

E. **Asset Smoothing Method:** The Asset Smoothing Method should aim to reduce the effect of short-term market volatility by gradually recognizing actuarial investment gains and losses over a period of time while still tracking the overall movement of the Fair Value of Assets. The Asset Smoothing Method should be unbiased relative to market; that is, the same smoothing period should be used to recognize gains and losses. To reduce volatility, gains and losses from different periods may be offset.

F. **Contribution Method:** The employer contribution rate shall be the sum of the Employer Normal Cost Rate (the Normal Cost Rate for the upcoming year less the expected member contribution rate) plus a contribution to pay off / recognize the Unfunded Actuarial Accrued Liability (UAAL) / Actuarial Surplus. The contribution for the Employer Normal Cost Rate varies by plan, and the contribution rate for the UAAL is dependent on the Funded Ratio (the ratio of the Valuation Assets to the Actuarial Accrued Liability).

a. **Employer Contribution Rate when Funded Ratio Less than 100%**

i. The Employer Normal Cost Rate for the year, plus

ii. An amortization payment / credit on the increase / decrease in the UAAL due to the current years' experience and other changes (current UAAL layer), plus

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

V. Policy (Continued)

b. Additional Conditions:

i. In no case shall the total amount contributed by the employer be less than the Employer Normal Cost Rate for the year plus a 30-year amortization of the total UAAL (for compliance with Section 31453.5 of CERL).

ii. Each year's amortization payment / credit should be over a period such that the amount being amortized is projected to decrease (i.e., no Negative Amortization) in each future year.

iii. If an increase in the UAAL is due to a change in plan provisions, a shorter amortization period used should be considered that is consistent with the expected lifetime of those expected to benefit. For example, if the change only impacts the retired population, a period of no longer than 10 years should be used.

c. Employer Contribution Rate when Funded Ratio is Greater than 100% but Less than 120%

i. The Employer Normal Cost Rate. There is no amortization payment / credit, in conformance with California Government Code Section 7522.52 of PEPRA.

d. Employer Contribution Rate when Funded Ratio is Greater than 120%

i. The Employer Normal Cost Rate for the year, less;

ii. An amortization of the Actuarial Surplus, but only if all conditions in California Government Code Section 7522.52(b) are met. The Actuarial Surplus is defined as the Valuation Assets in excess of the Actuarial Accrued Liability on the valuation date, and the surplus amount is amortized over 30 years. This is an open amortization period, so it is reset to 30 years each year if the Funded Ratio remains over 120%.

G. Discretionary Benefits: The BOI may consider additional actions to fund discretionary benefits as permitted under the CERL by using funds in excess of the amount needed to meet the Funding Goal. "Excess Earnings" as defined in the CERL may be appropriated upon reaching the Funding Goal, however, the BOI may consider adjustment to the employer's contributions only upon satisfying California Government Code Section 7522.52(b).

H. Interest Crediting: LACERA maintains a separate interest crediting policy to allocate Realized Earnings to the various reserve accounts.

LACERA

VI. References

These references are intended to help explain this policy and are not an all-inclusive list of policies, procedures, laws, and requirements. The following information complements and supplements this document:

Related Policies:

- Interest Crediting Policy for Reserve Accounts, Effective: July 1, 2024

Related Procedures: Not Applicable

Related Forms/Templates: Not Applicable

Other Related Information: Not Applicable

VII. Version History

Policy Approval Date: Board of Investments, October 9, 2024

Update/Review Summary: Previous policy version(s) superseded by this policy:

- Retirement Benefit Funding Policy, February 13, 2013

Original Issue Date: Adopted by the Board of Investments on December 9, 2009

VIII. Policy Review/Approval

The Board of Investments will review and update this Policy every three years, at a minimum, typically when the triennial investigation of experience study report is completed.