INTEREST CREDITING POLICY FOR RESERVE ACCOUNTS

BOARD OF INVESTMENTS
ADOPTED: OCTOBER 2024

Interest Crediting Policy for Reserve Accounts

Authorizing Manager: Ted Granger, Chief Financial Officer

Original Issue Date: N/A, included in former Retirement Benefit Actuarial Funding Policy, as amended, February 13, 2013

Effective Date: July 1, 2024 **Last Updated: October 9, 2024**

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

Approval Level: Board of Investments

I. Purpose

The purpose of this policy is to:
1. Define the reserve accounts maintained by LACERA;
2. Describe the methodology to credit interest to the reserve accounts of LACERA; and
3. Outline a process for allocating any "undistributed earnings" of LACERA.

II. Scope

This policy guides LACERA's Financial and Accounting Services Division (FASD) in allocating Available Earnings to reserve accounts and is performed semi-annually.

III. Legal Authority

LACERA is a public retirement plan duly created and operating under the County Employees Retirement Law of 1937, set forth at California Government Code Section 31450 et seq. Pursuant to Section 31591 of the County Employees Retirement Law of 1937 (CERL), regular interest shall be credited semi-annually on June 30 and December 31 to all eligible member contributions in the retirement fund, which have been on deposit for six months immediately prior to such date at an interest rate determined by the Board of Investments. CERL includes other provisions guiding the allocation of earnings, all of which must be exercised pursuant to the fiduciary duties of prudence and loyalty owed by the Board of Investments and its trustees to members and their beneficiaries under Article XVI, Section 17 of the California Constitution.

IV. Definitions

For this Policy, the terms below shall 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.

IV. Definitions (continued)

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

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.

Assumed Rate of Investment Return: The investment rate of return assumption adopted by the Board of Investments with the Funding Valuation that established the employer and employee contribution rates for the fiscal year that includes the Interest Crediting Date.

Available Earnings: Realized Earnings for the six-month period ending on the Interest Crediting Date plus prior period ending balances in the Contingency Reserve and Undistributed Earnings Reserve. Available Earnings may be negative.

Book Value of Assets (BVA): The Fair Value of Assets (FVA) minus any Unrealized Earnings. It is the original cost of the asset plus all earnings on the asset other than unrealized appreciation/depreciation and is equal to the sum of Valuation Reserves plus Non-Valuation Reserves.

County: Los Angeles County

County Employees Retirement Law of 1937 (CERL): Body of law enacted to govern retirement benefits for certain public employees. The CERL governs retirement systems (including LACERA) for county and district employees in those counties adopting its provisions pursuant to Section 31500.

Employer: Participating employers in LACERA include Los Angeles County, Los Angeles County Superior Court, South Coast Air Quality Management District (SCAQMD), Los Angeles County Office of Education (LACOE), Little Lake Cemetery District (LLCD), Local Agency Formation Commission for the County of Los Angeles (LAFCO).

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

Funding Valuation: An actuarial valuation that provides a comprehensive assessment of the financial and funding status of a pension plan and calculates employer and member contribution rates. The report is prepared by an external actuary who is independent of the retirement plan.

Interest Crediting Rate: This is the target interest rate to be credited to the Employer Reserve on each Interest Crediting Date. Pursuant to Section 31591 of the CERL the Board of

IV. Definitions (continued)

Investments determines the semiannual interest rate to be credited on each Interest Crediting Date. By this Interest Crediting Policy for Reserve Accounts, the Board of Investments sets the semiannual Interest Crediting Rate equal to one-half of the Assumed Rate of Investment Return. The target rate of interest will only be credited to the Employer Reserve if there are sufficient Available Earnings after first crediting both the Member Reserve and the Contingency Reserve as provided in this Policy, and therefore the amount credited to the Employer Reserve may be less than this rate if Available Earnings are insufficient to credit the entire amount.

Interest Crediting Date(s): Interest crediting shall be performed twice per year, as of June 30 and December 31.

Member Crediting Rate: This is the interest rate to be credited to member accounts on each Interest Crediting Date. Pursuant to Section 31591 of the CERL, the Board of Investments determines the semiannual interest rate to be credited to Member Reserves on each Interest Crediting Date. By this Interest Crediting Policy for Reserve Accounts, the Board of Investments sets the semiannual Member Crediting Rate equal to one-half of the Assumed Rate of Investment Return for that semiannual interest crediting period. This rate will be credited to the Member Reserve from Available Earnings. If Available Earnings are insufficient to credit this amount, the Undistributed Earnings Reserve will be debited by the amount of the shortfall (Section V.B below), such that the Member Crediting Rate will always be credited in full to the Member Reserve on each Interest Crediting Date regardless of the amount of Available Earnings.

Non-Valuation Reserves: Reserves that are set aside for obligations or contingencies and are excluded from Valuation Assets and the calculation of contribution rates in the Funding Valuation.

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

Unfunded Actuarial Accrued Liability (UAAL): The excess, if any, of the Actuarial Accrued Liability (AAL) over the Actuarial Value of Assets (AVA).

Unrealized Earnings: The accumulated appreciation or depreciation in value of assets held in the investment portfolio that has not yet been realized by the sale of those assets.

Valuation Assets: The value of assets used in the Funding 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.

Valuation Reserves: Reserves that will be included in the determination of Valuation Assets and the calculation of contribution rates in the Funding Valuation.

V. Policy

A. Reserve Accounts ("Reserves")

LACERA maintains the following reserve accounts for the purpose of allocating income and disbursements of the trust fund assets. Reserve accounts are classified as either Valuation Reserves or Non-Valuation Reserves. The sum of Valuation Reserves plus Non-Valuation Reserves is equal to the Book Value of Assets. Non-Valuation Reserves are not included in the Valuation Assets used in the Funding Valuation. These reserve balances are accounting balances and may not equal the Actuarial Value of Assets.

1. Valuation Reserves

a. **Member Reserve:** This reserve represents the total accumulated contributions, with interest, of members. Additions include member contributions and related earnings. Deductions include payments to retirees and refunds to members.

b. **Employer Reserve:** This reserve includes the total accumulated contributions, with interest, of the employer. Additions include contributions from employers and related earnings. Deductions include payments to retired members and survivors.

c. **Undistributed Earnings Reserve.** The accumulation of Available Earnings not yet allocated to any other Valuation or Non-Valuation Reserve. This reserve is used for semi-annual interest crediting, to eliminate the Unfunded Actuarial Accrued Liability by allocating excess amounts to the Employer Reserve, and for other uses at the joint discretion of the Board of Investments and Board of Retirement as permitted under CERL, and subject to the LACERA Actuarial Funding Policy. Specifically, this reserve should be used to eliminate the Unfunded Actuarial Accrued Liability prior to any other discretionary uses, by reallocating an amount to the Employer Reserve. The balance of this reserve may be negative.

2. Non-Valuation Reserves

a. **Contingency Reserve:** This is a statutorily defined reserve pursuant to Sections 31592 and 31592.2 of the CERL. The Contingency Reserve is set at 1.0% of the Fair Value of Assets as a reserve against deficiencies in interest earnings in other years, losses on investments, and other contingencies and other purposes permitted under CERL.

b. **STAR Reserve:** Reserves accumulated for the payment of cost-of-living benefits pursuant to Section 31874.3 of the CERL. Supplemental Targeted Adjustment for Retirees (STAR) benefits provide supplemental cost-of-living payments to retired members to restore purchasing power at a specified percentage level. The STAR Reserve does not receive interest credits.

V. Policy (Continued)

B. Crediting of Interest / Allocation of Available Earnings Process

The first step in the interest crediting process at each Interest Crediting Date is to determine Available Earnings. Available Earnings are equal to Realized Earnings for the six-month period ending on the Interest Crediting Date plus prior period ending balances in the Contingency Reserve and Undistributed Earnings Reserve. As a result of the prior period Contingency Reserve and Undistributed Earnings Reserve being included in Available Earnings, those reserve balances are reset to zero ($0) at this step. Throughout this process, Available Earnings will be reduced by the amount of interest credited, or allocated, to each reserve.

Interest is credited / allocated to individual reserve accounts in the priority order outlined below.

1. **Member Reserve**

   Credit individual member contributions and accumulated interest that have been on deposit for at least six months prior to the Interest Crediting Date with interest at the Member Crediting Rate. The Member Crediting Rate is equal to one half of the applicable Assumed Rate of Investment Return for that interest crediting period. This rate will always be credited in full to the Member Reserve on each Interest Crediting Date regardless of the amount of Available Earnings. Reduce Available Earnings by the total amount of interest credited to member accounts.

2. **Contingency Reserve**

   Allocate an amount so that this reserve is equal to 1% of the Fair Value of Assets as of the Interest Crediting Date. This amount will always be allocated to the Contingency Reserve regardless of the amount of Available Earnings. If Available Earnings are insufficient to allocate this amount, the Undistributed Earnings Reserve will be debited by the amount of the shortfall (Section V.B.4 below). Reduce Available Earnings by the total amount allocated to this reserve.

3. **Employer Reserve**

   If there are Available Earnings remaining after the allocation to the Contingency Reserve, then credit interest at the Interest Crediting Rate to the Employer Reserve balance as of the prior Interest Crediting Date only to the extent there is sufficient remaining Available Earnings to credit this amount. If this amount of interest is greater than the remaining Available Earnings, credit the entire amount of remaining Available Earnings, but not less than zero ($0). The interest rate credited to this Employer Reserve will be no less than 0% and no more than one-half of the Assumed Rate of Investment Return. The actual interest rate credited will depend on the amount of remaining Available Earnings after the allocation to the Contingency Reserve. Reduce Available Earnings by the amount of interest credited to this reserve.

V. Policy (Continued)

4. Undistributed Earnings Reserve

If there are positive Available Earnings remaining after the allocation to the Employer Reserve, allocate any remaining Available Earnings to this reserve.

If there are zero ($0) Available Earnings remaining after the allocation to the Employer Reserve, then no allocation shall be made to this reserve.

If there are negative Available Earnings remaining after the allocation to the Member Reserve and the Contingency Reserve, no interest shall be credited to the Employer Reserve and the amount of those negative Available Earnings shall be allocated to this reserve.

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:

- Actuarial Funding Policy, Effective: July 1, 2024

Related Procedures:

- Interest Crediting Internal Accounting Procedures, June 12, 2024

Related Forms/Templates: Not Applicable

Other Related Information: Not Applicable

VII. Version History

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

Policy Update/Review Summary: Previous policy language included, and 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 actuarial experience study report is completed.

APPENDIX

LACERA

	Interest Crediting Examples	Scenario #1	Scenario #2	Scenario #3
		Available Earnings less than amount needed for Member Reserve Interest Credit + Contingency Reserve Allocation	Available Earnings greater than amount needed for Member Reserve Interest Credit + Contingency Reserve Allocation but not enough for full Employer Reserve Credit	Available Earnings greater than amount needed for Member Reserve Interest Credit + Contingency Reserve Allocation + full Employer Reserve Credit
	Pension Plan Reserves as of June 30, XXXX			
(1)	Member Reserve	$30,000,000,000	$30,000,000,000	$30,000,000,000
(2)	Contingency Reserve	$800,000,000	$800,000,000	$800,000,000
(3)	Employer Reserve	$35,000,000,000	$35,000,000,000	$35,000,000,000
(4)	Undistributed Earnings Reserve	$200,000,000	$200,000,000	$200,000,000
(5)	STAR Reserve	$610,000,000	$610,000,000	$610,000,000
(6)	Total Reserves at Book Value	$66,610,000,000	$66,610,000,000	$66,610,000,000
	December 31, XXXX			
(7)	Fair Value of Assets as of December 31, XXXX	$82,000,000,000	$82,000,000,000	$82,000,000,000
(8)	Unrealized Investment Portfolio Appreciation as of December 31, XXXX	$16,000,000,000	$16,000,000,000	$16,000,000,000
(9)	Realized Earnings for the Period	$0	$1,220,000,000	$2,200,000,000
(10)	1.0% Fair Value of Assets as of December 31, XXXX	$820,000,000	$820,000,000	$820,000,000
	Step 1 - Determine Available Earnings as of December 31, XXXX			
(11)	Realized Earnings for the Period [= (9)]	$0	$1,220,000,000	$2,200,000,000
(12)	Contingency Reserve as of June 30, XXXX [= (2)]	$800,000,000	$800,000,000	$800,000,000
(13)	Undistributed Earnings Reserve as of June 30, XXXX [= (4)	$200,000,000	$200,000,000	$200,000,000
(14)	Available Earnings	$1,000,000,000	$2,220,000,000	$3,200,000,000
	Step 2 - Reset Pension Plan Reserves as of June 30, XXXX after determination of December 31, XXXX Available Earnings			
(15)	Member Reserve [= (1)]	$30,000,000,000	$30,000,000,000	$30,000,000,000
(16)	Contingency Reserve [a] [= (2) - (12)]	$0	$0	$0
(17)	Employer Reserve [= (3)]	$35,000,000,000	$35,000,000,000	$35,000,000,000
(18)	Undistributed Earnings Reserve [a] [= (4) - (13)]	$0	$0	$0
(19)	STAR Reserve [= (5)]	$610,000,000	$610,000,000	$610,000,000
(20)	Total Reserves at Book Value	$65,610,000,000	$65,610,000,000	$65,610,000,000
	Step 3 - Pension Plan Reserves Interest Crediting & Allocations as of December 31, XXXX			
(21)	Member Reserve credit (always equal to one-half of investment return assumption [b])	$1,050,000,000	$1,050,000,000	$1,050,000,000
(22)	Contingency Reserve allocation (always reset to 1% of Fair Value of Assets) [= (10)]	$820,000,000	$820,000,000	$820,000,000
(23)	Employer Reserve credit	$0 [c]	$350,000,000 [e]	$1,225,000,000 [f]
(24)	Undistributed Earnings Reserve allocation [d] [= (14) - (21) - (22) - (23)]	($870,000,000)	$0	$105,000,000
(25)	STAR Reserve credit	$0	$0	$0
(26)	Total Interest Crediting & Allocations	$1,000,000,000	$2,220,000,000	$3,200,000,000
	Step 4 - Determine Pension Plan Reserves as of December 31, XXXX			
(27)	Member Reserve [= (1) + (21)]	$31,050,000,000	$31,050,000,000	$31,050,000,000
(28)	Contingency Reserve [= (22)]	$820,000,000	$820,000,000	$820,000,000
(29)	Employer Reserve [= (3) + 23)]	$35,000,000,000	$35,350,000,000	$36,225,000,000
(30)	Undistributed Earnings Reserve [= (24)]	($870,000,000)	$0	$105,000,000
(31)	STAR Reserve [= (5)]	$610,000,000	$610,000,000	$610,000,000
(32)	Total Reserves at Book Value	$66,610,000,000	$67,830,000,000	$68,810,000,000

a *Contingency Reserve and Undistributed Earnings Reserve are reset to $0 at the beginning of each cycle when these amounts are included in Available Earnings for that cycle.*

b *The investment return assumption referred to here is the assumption adopted by the Board of Investments with the Funding Valuation that established the employer and employee contribution rates for the fiscal year that includes the Interest Crediting Date. For the purpose of these examples one-half of the investment return assumption is 3.50%.*

c *The effective interest rate credited to the Employer Reserve is 0% because Available Earnings are less than the amount needed to provide interest crediting to the Member Reserve and to establish the Contingency Reserve equal to 1% of the Fair Value of Assets.*

d *The Undistributed Earnings Reserve is allocated with the excess (or shorfall) of Available Earnings over the amounts credited (or allocated) to the Member Reserve, Contingency Reserve and Employer Reserve.*

e *Available Earnings are greater than the amount needed to provide interest crediting to the Member Reserve and to establish the Contingency Reserve equal to 1% of the Fair Value of Assets, but are insufficient to provide interest crediting equal to one-half of the investment return assumption. As such, the full amount of remaining Available Earnings is credited to the Employer Reserve. The effective interest rate credited to the Employer Reserve in this example is 1% ($350,000,000 / $35,000,000,000).*

f *Available Earnings are greater than the amount needed to provide interest crediting to the Member Reserve, to establish the Contingency Reserve equal to 1% of the Fair Value of Assets, and to provide interest crediting equal to one-half of the investment return assumption. As such, the Employer Reserve receives an interest credit of 3.5% ($1,225,000,000 / $35,000,000,000).*

These example scenarios ignore contributions & benefit payments from reserves (for simplification). All amounts are for illustration only.