Board of Supervisors
Kern County Administrative Center
1115 Truxtun Avenue
Bakersfield, CA 93301

REPORT REGARDING KERN COUNTY EMPLOYEES' RETIREMENT ASSOCIATION
PHASE-OUT OF THE RETIREMENT CONTRIBUTION PREPAYMENT PROGRAM
Fiscal Impact: None

This is to provide your Board with information regarding the decision of the Kern County Employees’ Retirement Association (KCERA) Board to phase out the retirement contribution prepayment program by the end of Fiscal Year 2016-17.

The County has been prepaying its annual retirement contributions since Fiscal Year 2000-01 with the exception of Fiscal Year 2002-03 when the practice was suspended but resumed in the following year. Employer retirement contribution rates are set by KCERA’s actuary and incorporate an interest charge in recognition that contributions are collected in installments throughout the fiscal year. If the County instead pays all estimated employer retirement contribution by the statutory deadline of July 30 of each year, the County receives one-half of the actuarial discount rate (3.75%) as an interest adjustment or discount. The annual discount of approximately $8 million allows the County to reduce its cash payment to KCERA and provides an additional source to public services.

On June 10, 2015 KCERA’s Executive Director presented the recommendation approved by the KCERA Finance Committee to eliminate the retirement contribution prepayment program within the next three fiscal years. The staff report is attached for reference. The KCERA Board approved a phase out plan that includes:

Year 1: Continue the program for Fiscal Year 2015-16 in its current form using one-half (3.75%) of the assumed rate of return as the discount rate;

Year 2: In Fiscal Year 2016-17, reduce the discount rate to one-fourth (1.875%) of the assumed rate of return; and

Year 3: In Fiscal Year 2017-18, eliminate the prepayment program discount.

It is staff’s understanding that this decision was based on the KCERA Chief Investment Officer’s (CIO) recommendation to eliminate the perceived unfavorable interest risk profile under the existing program which limits KCERA’s ability to earn the assumed rate of return (7.5%) on the prepayment amount and results in increases to the unfunded actuarial liability the County pays in subsequent years.
In light of the budgetary challenges facing the County and the limited time the County would have had to address them in Fiscal Year 2015-16, the KCERA Board agreed to keep the prepayment program in its current form for Fiscal Year 2015-16. The County received a discount of approximately $8.1 million. In Fiscal Year 2016-17, it is estimated that this discount will be reduced to approximately $4.1 million with the complete elimination of the discount in Fiscal Year 2017-18. The County Administrative Office will provide your Board with options to address the budgetary impacts as part of the Mid-Year Budget report in January.

Gloria Dominguez, Executive Director of the KCERA, has agreed to be present to provide KCERA’s perspective on the issue.

Therefore, IT IS RECOMMENDED that your Board receive and file this report.

Sincerely,

John Nilon
County Administrative Officer

Attachment

cc: Kern County Employees’ Retirement Association
Date: June 10, 2015

To: Trustees, Finance Committee
    Board of Retirement

From: Gloria M. Domínguez, Executive Director
    Peter Tirp, Chief Investment Officer

Subject: Response to Referral to Review Plan Sponsor Retirement Contribution Prepayment Program

Executive Summary

A review of the plan sponsor retirement contribution prepayment program ("program"), as authorized by Government Code Section 31582, was referred to staff. The Finance Committee met on March 11, 2015 and on May 28, 2015 to discuss the recommendations from staff. Members of the County Administrative Office ("CAO") were also heard.

On March 11, the Finance Committee referred the matter back to staff to work with the County and affected district to develop a proposed three-year plan to either eliminate the program indefinitely in year three or modify it to discount the prepayment using a rate equal to 60% of the U.S. Treasury Year-Bill yield on the last business day of the previous fiscal year. Additional options were considered and recommended by the Finance Committee for implementation as advised by KCERA's actuary for the retirement contribution prepayments made in years one and two of the three-year plan.

Discussion

On May 28, the Finance Committee met to review the proposed three-year phase-out plan recommended by staff. The County Administrative Office provided an alternative approach to the program. Their correspondence is included in Attachment A in a letter dated May 15, 2015. In essence, the CAO wishes to continue the program in its current form for FY 2015-16 indefinitely using one-half (3.75%) of the assumed rate of return as the prepayment discount rate. In all succeeding fiscal years, the CAO wishes to continue with the program using the same discount rate as in previous years and modifying the calculation of the prepayment and discounted amount using a different methodology. After review of the correspondence from the County and the actuary's review of the correspondence and proposed calculation methodology, staff recommends that the retirement contribution prepayment program be discontinued in the following three-year phase-out plan:

1. In FY 2015-16: continue the program in its current form using one-half (3.75%) of the assumed rate of return as the prepayment discount rate;
2. In FY 2016-17: reduce the prepayment discount rate to one-fourth (1.875%) of the assumed rate of return; and

3. In FY 2017-18: eliminate the prepayment program and return to biweekly retirement contribution payments.

Further, in FYs 2015-16 and 2016-17, staff recommends that the CAO implements the actuary’s suggested modifications to the calculation of the prepayment and discounted amount and submit the draft calculation to KCERA for review and approval by the actuary. KCERA will reconcile the prepaid contributions to the actual contributions at the end of the contribution year and adjust accordingly.

**CIO Discussion**

The prepayment program is a riskless arbitrage to the County, which can borrow money maturing in 12 months at essentially the same rate of interest as similar tenor, effectively riskless US Treasury debt. As an example, the County issued a Tax and Revenue Anticipation Note (TRAN) on June 30, 2014 at an Initial Offering Yield of 0.11%. On the same date, the One-Year US Treasury Bill also yielded 0.11%. The County can use the TRAN’s proceeds to make a lump-sum payment to KCERA at 3.75% less than the actuarially determined amount due if the discount were not in effect. In dollar terms, the County paid KCERA $8 million less than it would have if the County paid an undiscounted contribution in 26 equal installments in FY 2014-15.

In theory, KCERA could invest the entire discounted lump sum in liquid public markets and hopefully make up the difference. However, this is simply not realistic given KCERA’s obligation to pay monthly benefits and the near-certainty of periodic market declines. It is important also to bear in mind that our 7.5% assumed rate of return is the long-term rate KCERA expects to earn on its entire portfolio including highly-illiquid, long-term assets like private equity and real estate while the pre-payment contribution and its associated discount rate covers a period of one year.

From an operational perspective, KCERA typically invests the bulk of the discounted lump-sum prepayment in stock and bond indices and makes monthly withdrawals to fund scheduled benefit disbursements. These vehicles are fully subject to market volatility. Any early losses on the prepayments cannot be recovered by a subsequent market recovery once cash has been disbursed for benefits, so KCERA is accepting a very unfavorable risk profile under the current structure.

The risk asymmetry is particularly severe in the first months of the fiscal year. KCERA typically receives its lump sum payment during the last week of July and sends out its July payroll on the last business day of the month. In order to earn the portfolio’s assumed rate of return and fully recover the prepayment discount KCERA would need to earn in excess of 11% on one-twelth of the prepayment in less than three days. There is absolutely no prudent way we can expect a return that high in three months, much less in three days. A similar, although slightly less severe, arithmetic is in effect for the second month and each month thereafter. KCERA bears the entire short-term risk of almost-certain underperformance, that
must then be passed along to all stakeholders within the pool in the form of higher contribution rates to fund incrementally higher Unfunded Actuarial Accrued Liability (UAAL).

The County’s most recent proposal to KCERA includes an offer to pre-pay their discounted annual contribution by July 10th rather than during the last week in July. While this gesture is appreciated it is important to note that given KCERA’s approximately $23 Million monthly payroll it represents less than a $400 gain than if the prepayment were received in the last week as has been the case for the past 15 years. This _de minimus_ benefit is a function of the near zero percent yields on short-dated risk free assets (see chart below) and assumes that we would invest the remainder of the annual contribution in liquid asset classes that are fully subject to sharp drawdowns.

This asymmetry of risk was significantly less pronounced when KCERA last evaluated the program in June 2000. Current staff reviewed daily interest rates from the US Treasury’s _Daily Treasury Yield Curve Rates_ database. The Treasury’s Year-Bill yielded between 6.21% - 6.93% from March through July of 2000. Over the same time frame, one-month T-Bills yielded between 5.63% - 6.18%. This was the 'riskless opportunity set' available to KCERA when it reviewed the prepayment discount methodology and allowed the County to take an approximately 4.00% discount on its lump-sum prepayment.

The difference in the rate regimes of 2000 and 2015 is that in 2000 KCERA could almost completely avoid taking market risk on the lump-sum prepayment by simply purchasing a riskless one year T-Bill yielding well over 6.00%, a one-month T-Bill earning over 5.60%, etc., thereby ‘locking-in’ a meaningful gain over the discount provided to the County. Employing a similarly effective strategy today or in the foreseeable future is impossible: the Year-Bill has yielded less than 0.25% during most of the last 12 months and is currently at 0.23%. One-month T-Bill yields have fluctuated between 0.02% and -0.02% over the same time frame.

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**Conclusion and Recommendation**

There are options available for the board’s consideration. The CAO is requesting your consideration of their proposal to continue the program with modifications to the calculation of the prepayment and discounted amount. Staff proposes to eliminate the retirement contribution prepayment program within the next three fiscal years as described above.

Therefore, staff recommends that the Board approve the three-year phase-out plan of the plan sponsor retirement contribution prepayment program.
Gloria M. Dominguez  
Executive Director  
Kern County Employees’ Retirement Association  
11125 River Run Boulevard  
Bakersfield, CA 93311  

RE: Retirement Contribution Prepayment Program  

Dear Ms. Dominguez,

Thank you for the opportunity to review the anticipated recommendation to the Finance Committee for a phase-in of the County Prepayment of the retirement contribution. It is our understanding that you will be making the following recommendation:

Year 1: Continue the program for FY 2015-16 in its current form using one-half (3.75%) of the assumed rate of return as the discount rate;

Year 2: For FY 2016-17, reduce the discount rate to one-fourth (1.875%) of the assumed rate of return;

Year 3: For FY 2017-18 eliminate the prepayment program.

In addition, the recommendation will include the items identified by the actuary and discussed in your March 11, 2015 report, as well as the receipt of prepayment in the first week in July in order to maximize the investment return potential.

In light of the significant budgetary challenges the County faces and the limited time the County would have to address any changes in FY 2015-16, the County appreciates your willingness to recommend status quo for FY 2015-16. As proposed in our letter dated March 26, 2015, the County continues to propose an alternative for FY 2016-17 and beyond that we believe is fair. As stated in your March 11, 2015 report to the Finance Committee, KCERA’s actuary, Segal Consulting, has reviewed the County’s current methodology for calculating the discounted prepayment amount for each rate group and overall has found it to be actuarially sound. It is our understanding that the actuary’s rate calculation includes an interest adjustment in the rate under the assumption that the County will pay the employer’s contribution on a biweekly basis, not as an upfront prepayment. This interest rate increase negates the discount KCERA is offering the County for early prepayment, as it just removes one-half of the interest charge built into the employer contribution rates.

As an alternative, the County proposes therefore to continue using one-half of the actuarial discount rate for FY 2016-17 and beyond with the prepayment calculated using the present value of the discounted cash flows beginning in FY 2016-17 instead of the using the simple interest and the lump sum estimated annual employer contribution. This change in the calculation methodology takes into consideration KCERA’s concern regarding the risk asymmetry, particularly in the first month of the fiscal year when KCERA receives its lump sum payment and sends out its July payroll on the last business day of the month, and it reduces the discount from approximately $8 million to $4 million based on the County’s estimated payroll.
It is our hope that the KCERA Board will give serious consideration to this proposal that we believe to be fair, actuarially sound and mutually beneficial for both agencies.

Sincerely,

[Signature]

Johin Nilon
County Administrative Officer

cc: Board of Supervisors
March 26, 2015

Kern County Employees’ Retirement Association
Mrs. Gloria M. Dominguez
Executive Director
11125 River Run Boulevard
Bakersfield, California 93311

Re: Retirement Contribution Prepayment Phase-Out

Dear Mrs. Dominguez:

After further discussion and reviewing the information provided to the KCERA Finance Committee, the County Administrative Office requests that KCERA continue the program currently in place, using one-half of the actuarial discount rate with the following modifications:

1. Prior to January 31, the County will submit a draft calculation of the prepayment and discount amount for KCERA review and approval.
2. The prepayment will be made no later than July 10 of each fiscal year.
3. The prepayment will be calculated using one-half of the actuarial discount rate when calculating the present value of discounted cash flows.
4. The prepayment will be based on payroll estimates calculated by the County to reflect budget constraints resulting from projected salary cost reductions.
5. KCERA will compare payroll estimates used to calculate the prepayment amount to the actual amount each pay period. Should actual payroll be 10% greater than estimated payroll for six consecutive pay periods, the County will be required to pay additional contributions each pay period for the additional salary above the projected salary used to calculate the prepayment, with no additional discount applied to the additional amount.
6. KCERA will reconcile the prepaid contribution to the actual contribution at the end of the contribution year and adjust for actual salaries.

This methodology removes the interest adjustment built into the contribution rates which are calculated assuming the County will not make its annual required contribution at the beginning of the year. This methodology also benefits KCERA’s cash flow by offsetting disbursements to retirees and administrative expenses, which could otherwise exceed incoming contributions. KCERA’s investment officer has stated that meeting these obligations could require liquidation of long term investments.

Additionally, the County recognizes that there will be short-term actuarial gains/losses that would result in lower/higher contributions when the actuarial experience is recognized in subsequent valuations. The County does not win or lose relative to the pension plan since the County ultimately pays for gains or losses. Since the County’s actuarial experience is not pooled with all participating employers in KCERA, prepaying the annual required contribution does not spread the County’s risk among other employers.
Finally, the County recognizes that in extreme market conditions (e.g., recession) it would be prudent to suspend the program and evaluate it in the subsequent year.

**Phase-out Approach**
The KCERA Finance Committee has requested a phase-out of the prepayment program. Although the County Administrative Office does not propose that KCERA adopt this change, in light of this request, the County proposes the following:

1. Continue the program through Fiscal Year 2015-16 in its current form.
2. In Fiscal Year 2016-17, reduce the discount to one-third of the actuarial discount rate.
3. In Fiscal Year 2017-18 and thereafter reduce the discount to one-fourth of the actuarial discount rate.

We look forward to meeting with you to further discuss this proposal.

Sincerely,

John衬衫
County Administrative Officer