The Pension Trust

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<u>The Cost of Your Pension</u>

The SLO County Retirement Plan is a traditional "Defined Benefit" pension – and they are expensive – no way around it. Employees pay pension contributions to the Plan and their employer pays even more to the Plan. Employees' contributions come back to them as a refund + interest if they leave pre-vested (5 years). Vested employees who retire and draw a pension have their contributions funding part of that benefit.

Each year an Actuary does the Annual Actuarial Valuation which calculates what pension contributions are needed to fund the Plan responsibly and prudently. Pension contributions cover the "Normal Cost" of the Plan for each year of added pension service. They also include an amount to fund the Unfunded Actuarial Liability (UAL) over the next 19 years to bring the Plan from 65% to 100% funded. Pension costs vary by class of member (Miscellaneous, Probation, Safety) and by Tier (1, 2, and 3 depending on when members were hired). The total pension contribution rate needed for Miscellaneous employees across all 3 tiers averages 47.4% of pay in 2021. Ouch!

The total pension contribution rate rose about 4% of pay for 2020 (effective July 2021) and will increase again about 2% of pay for 2021 (effective July 2022). These increases are split between the employee and the employer by union negotiations. Typically increases have been split 50/50 but with caps on how much can be allocated to employees over the term of the MOU. The Pension Trust does not determine the allocation of pension costs between employee and employer. It's like a restaurant - the Pension Trust and its Actuary deliver the total bill for the meal to the table and the diners decide how they want to split up the tab.

Out of the 47.4% of pay that the pension costs for Miscellaneous employees, on average, over 12% is paid by employees leaving about 35% to be paid by the employer. Some bargaining units in Tiers 1 & 2 have a portion of the employee rate "picked up" by the employer as well, but such pick-ups are banned by State law for Tier 3. Each individual employee's contribution rate depends on their age at hire (younger hires pay lower rates).

Part of the reasons for pension cost increases has been increasing life expectancy – the pension gets paid for more years on average. But investment returns in the long shadow of the 2008 Global Financial Crisis have been a larger cause of increases. Actuarial Valuations smooth investment returns over many years and the hangover from 2008 was still hurting pension costs through 2019.

Recent investment returns in 2019 (+16.3%) and 2020 (+8.9%) will help as they get averaged into the Actuarial Valuations over the next several years.

Importantly, Actuarial Valuations measure pension liabilities and calculate needed contribution rates based on the Discount Rate applied to future liabilities (all those future pensions yet to be paid out). The Discount Rate must equal the long-term expected investment return of the pension fund. A lower Discount rate increases costs. The Pension Trust had a Discount Rate of 7.25% in 2015, but that has decreased to 6.75% by 2021. This decrease in the Discount Rate has a large impact on the rate of pension contributions.

A few good years for investment returns help, but the 40+ year outlook for future returns is more important to the Discount Rate. Pension funds invest in a mix of stocks and bonds to moderate their risk. Bond interest rates are artificially low and likely to stay low for a decade. Bonds that were once yielding over 7% are now lucky to get 3%. With the stock market at record highs in 2021, the old adage of "what goes up must come down" applies to the future. Investment consultants that years ago expected 9% returns from stocks now expect stocks to return around 5%. The Pension Trust, like many pension funds, has turned to higher return investments such as private equity, but even with those it is hard-pressed to justify even a 6.75% discount rate. Hence the downward pressure on Discount Rates and the accompanying upward pressure on pension contribution rates. Ouch again!