

July 8, 2021

Mr. Donald C. Kendig
Retirement Administrator
Fresno County Employees' Retirement Association
7772 N Palm Ave
Fresno, CA 93711

**Re: Fresno County Employees' Retirement Association (FCERA)
Hypothetical Phase-ins of the Increase in Employer's UAAL Contribution Rate due
to Changes in Economic Actuarial Assumptions for the June 30, 2021 Actuarial
Valuation**

Dear Don:

We have been requested to provide information on a hypothetical two-year "phase-in" of the increase in employer's unfunded actuarial accrued liability (UAAL) contribution rate due to changes in economic assumptions that were adopted based on our review of economic actuarial assumptions for the June 30, 2021 actuarial valuation. This letter provides an illustration of the phased in contribution rate and discusses the impact of the phase-in on the ultimate employer contribution rate after the phase-in is over.

Background

In our economic assumptions review report dated June 8, 2021, we estimated that if all the recommended economic actuarial assumptions, including a 6.50% investment return assumption and a 2.50% inflation assumption, were to be adopted by the Board, the aggregate employer contribution rate would increase by 4.65% of payroll¹ and the aggregate member rate would increase by 0.63% of payroll. (Those and other assumptions recommended in our June 8, 2021 report were adopted by the Board at its meeting on June 16, 2021.)

Please note that the discussion in this letter reflects the general practice that, even when changes in employer rates are phased in, changes in the member rates due to assumption changes are not phased in. There are two main reasons for that practice. The principal reason is that, because the phase-in increases the UAAL and the UAAL is funded only by the employer, a phase-in of the member rates would in effect shift cost from the employees to the employers.

¹ The aggregate employer rate increase of 4.65% of payroll has been calculated without taking into consideration the expected reduction in the employer's UAAL contribution rate in the next several years as some of FCERA's prior UAAL amortization layers are being fully amortized. For instance, there are expected reductions in the UAAL rate of 3.78% in the June 30, 2021 valuation and further reduction of 3.81% (for a cumulative reduction of 7.59%) in the June 30, 2022 valuation.

In addition, because member contribution rates are based solely on normal cost and are unaffected by changes in the UAAL, the cost impact on member rates is generally smaller than the impact on employer rates.

This letter illustrates only a phase-in of the UAAL amortization component of the employer rate increase. In practice, this is usually most of the cost impact. For example, of the 4.65% of rate impact noted above, 3.31% is due to UAAL amortization and 1.34% is due to normal cost.

We would advise the Board of Retirement that phasing in of the employer's contribution rate impact of assumption changes is a common practice both nationally and especially here in California. Some systems routinely phase in such rate changes whenever assumptions are changed and the cost impact is above some threshold amount. Furthermore, guidance on actuarial funding policy from both the California Actuarial Advisory Panel and the Conference of Consulting Actuaries views this as an acceptable practice as long as the phase-in period is no longer than the time until the next review of the economic actuarial assumptions that the Board has scheduled before the June 30, 2023 valuation, just as is being illustrated here.

Impact of Two-Year Phase-in of Only the Employer UAAL Contribution Rate Change

For illustration purposes in this letter only, we have assumed that the effect of the changes in economic actuarial assumptions that were adopted based on the recent economic actuarial assumptions study would be to increase the employer's UAAL contribution rate in the June 30, 2021 valuation by 3.31% of payroll (about 3.09% and 4.36% of payroll for General and Safety, respectively), as estimated in the study based on the June 30, 2020 valuation.² Under this scenario, the 3.31% would be phased in over two years starting with the June 30, 2021 valuation, which establishes the employer and member contribution rates for the 2022/2023 fiscal year. The actual amount phased in would be determined as part of the June 30, 2021 annual valuation.

The following is a general description of how a two-year phase-in would work:

- The portion of the employer contribution to be phased in would be determined one time, as part of the June 30, 2021 valuation. That total fixed amount would not be redetermined in later valuations. In this illustration, that amount is 3.31% of payroll.
- In the June 30, 2021 valuation, the actual employer contribution rate would immediately increase by the full 1.34% of payroll due to the change in normal cost. The actual employer contribution rate would also reflect one-half of the impact of the change in the UAAL amortization rate. In this illustration, that amount is 1.66% of payroll ($1/2 \times 3.31\%$). In other words, the actual employer rates would defer recognition of one-half of the impact by subtracting 1.65% from the employer rate determined in the June 30, 2021 valuation.
- In the June 30, 2022 valuation, the employer contribution rate would reflect the full impact of the change in UAAL amortization rate shown above, or 3.31% of payroll. None of the original

² The 4.65% increase in the total employer rate is made up of a 3.31% increase in the UAAL amortization rate and a 1.34% increase in the normal cost rate. These are aggregate impacts; in practice, we would calculate a different rate to be phased in based on each of the General and Safety membership groups.

impact would be deferred and there would be no deduction from the employer rate determined in the June 30, 2022 valuation.

During the phase-in period, the plan is not receiving the full UAAL amortization payments. That means that in the next actuarial valuation, there will be an actuarial loss that will increase the future UAAL and future UAAL contributions. This contribution loss will be amortized and funded over a period of 15 years starting with the actuarial valuation that follows the contribution loss (i.e., following the year of the phased in contribution). In our experience, contribution losses due to phase-ins are usually relatively small and so are not identified separately, but simply become part of "other gains and losses".

If the Board adopts the two-year phase-in only for the impact on UAAL amortization, the employer contribution rates would immediately increase by the full 1.34% due to the change in normal cost. The cumulative increase in only the aggregate employer UAAL amortization rates both before and after applying the phase-in is provided in the table below:

Cost Phase-in Applied Only to UAAL Amortization Rate

Cumulative Increase in Employer UAAL Rates

Fiscal Year	<u>Without Phase-in</u>	<u>With Phase-in</u>
2022 / 2023	3.31%	1.66%
2023 and later	3.31%	3.45%

When we then add in the full increase in the employer rate of 1.34% due to the change in normal cost, the total increases in the total employer rate would be as follows:

Cost Phase-in Applied Only to UAAL Amortization Rate

Cumulative Increase in Aggregate Employer Rates

Fiscal Year	<u>Without Phase-in</u>	<u>With Phase-in</u>
2022 / 2023	4.65%	3.00%
2023 and later	4.65%	4.79%

These tables show that, because of the contribution losses discussed earlier, the rate impact for the second year of the phase-in is somewhat higher than simply adding another one-half of the phased in amount to the contribution rates for the preceding year.

The above employer rate increases with phase-in do not reflect the expected reduction in the employer's UAAL contribution rate in the next two years as some of FCERA's prior UAAL amortization layers are fully amortized, as discussed in footnote (1). If those reductions are combined with the above employer rate increases with phase-in, the cumulative expected employer rate decreases are as follows:

- The 2022 / 2023 employer rate will decrease by 0.78% of payroll (i.e., 3.00% - 3.78%) and
- The 2023 / 2024 employer rate will decrease by 2.80% of payroll (i.e., 4.79% - 7.59%).

Both of the above rates are as compared to the employer rate determined in the June 30, 2020 valuation.

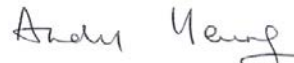
The undersigned are members of the American Academy of Actuaries and meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion herein.

Please let us know if you have any questions, and we look forward to discussing this with you and your Board.

Sincerely,



Paul Angelo, FSA, MAAA, FCA, EA
Senior Vice President & Actuary



Andy Yeung, ASA, MAAA, FCA, EA
Vice President & Actuary

OH/hy

cc: Deborah Paolinelli