



THE SEGAL COMPANY  
100 Montgomery Street, Suite 500 San Francisco, CA 94104-4308  
T 415.263.8200 F 415.263.8290 www.segalco.com

VIA EMAIL AND USPS

March 11, 2010

Ms. Sally Choi  
General Manager  
Los Angeles City Employees' Retirement System  
360 E. Second Street, Second Floor  
Los Angeles, CA 90012

**Re: Los Angeles City Employees' Retirement System  
Actuarial Funding Policies - Revised**

Dear Sally:

In this letter, we have summarized the actuarial funding policies discussions we had with the Retirement Board at the February 11, 2010 retreat. We have also included several alternative policies that may be considered by the Board for future actuarial valuations. Note that this replaces the February 19 version of this discussion that was presented to the Board on February 23, 2010.

### **GENERAL FUNDING POLICY GOALS**

This report starts with a general discussion of pension plan funding policies followed by detailed discussion of specific policy components along with various policy recommendations. This discussion is based on the following high level policy goals:

1. Future contributions and current plan assets should be sufficient to provide for all benefits expected to be paid to current active, inactive and retired members. This means that contributions should include the cost of current service plus a series of payments to fully fund any unfunded or prefunded past service costs.
2. The funding policy should seek a reasonable allocation of the cost of benefits to the years of service. This includes the goal that annual contributions should, at a minimum, maintain a close relationship to the cost of each year of service.
3. The funding policy should seek to manage and control future employer contribution volatility to the extent reasonably possible, consistent with other policy goals.



## GENERAL DISCUSSION OF PENSION PLAN FUNDING POLICIES

A pension plan funding policy is designed to determine how much should be contributed each year in total by the employer and the active members to provide for the secure funding of benefits in a systematic fashion. The funding policy starts with an actuarial cost method that allocates a portion of the total present value of the members' benefits to each year of service. In theory, contributing that "Normal Cost" for each year of service will be sufficient to fund all plan benefits, assuming that all actuarial assumptions are met including the assumed rate of investment return. In that ideal situation, plan assets will always be exactly equal to the value today of all the past Normal Costs (the Actuarial Accrued Liability or AAL), and the current contribution will be only the current Normal Cost.

In practice, for a variety of reasons, the assets will be greater than or less than the AAL, leaving the plan overfunded (surplus) or underfunded (the Unfunded Actuarial Accrued Liability or UAAL). The funding policy adjusts contributions to reflect any surplus or UAAL in a way that reduces short term, year-by-year volatility, but still assures that future contributions, together with current assets, will be enough to provide all future benefits.

A comprehensive funding policy is made up of three components:

1. An **actuarial cost method**, which allocates the total present value of future benefits to each year (Normal Cost) including all past years (AAL).
2. An **asset smoothing method**, which reduces the effect of short term market volatility while still tracking the overall movement of the market value of plan assets.
3. An **amortization policy**, which determines the length of time and the structure of the payments for the contributions required to systematically pay off the plan's UAAL.

In 2009, the Board conducted a comprehensive review of the asset smoothing method. As a result of that review, the Board decided to maintain its 5-year asset smoothing period but to expand the Market Value (MVA) Corridor so that the Actuarial Value of Assets (AVA) would be allowed to vary within a range of 50%-150% of the MVA. For that reason, in this report, we will focus our discussions on the actuarial cost method and the amortization policy, and then review the asset smoothing method briefly at the end of this report.

For governmental or public defined benefit plans, like LACERS, there are no specific external funding or funding policy requirements such as those established for single employer (corporate) and multiemployer (Taft-Hartley) defined benefit pension plans under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC). The accounting standards promulgated by the Governmental Accounting Standards Board (GASB) define an Annual Required Contribution (ARC) that, despite its name, is actually the amount of expense that the employer must recognize each year. Also, the GASB accounting standards provide considerable policy latitude when determining the ARC.

Even though this leaves governmental or public plans relatively free to set funding policy, it is worth noting that all long term funding policy structures – corporate, multiemployer and GASB – take the same form, at least for underfunded plans (plans with a UAAL):

1. Contribute the Normal Cost for the year, and
2. Contribute an additional amount that will fully fund (“amortize”) any UAAL over a period of years.

Implicit in this form of policy is a *funding target of 100 percent*, since at the end of the amortization period the plan will be fully funded. This is in contrast to “corridor” methods that allow contributions equal to only the Normal Cost as long as the plan is within, for example, 5 percent of being fully funded. The funding policy discussed here is based on the UAAL amortization method because it is well established for all types of pension plans as it targets 100 percent funding of the AAL. We also believe that this is consistent with the local legal requirements applicable to LACERS.

For LACERS, the actuarial cost method and the UAAL amortization policy were last reviewed by the Board in October 2005. While a general review of the UAAL contribution policy would include both the amortization periods and the structure of the amortization payments, the focus of the Board’s review in 2005 was on the merit of “restarting” the amortization period.

A detailed discussion of the selection of the UAAL amortization period and structure follows in the next section. For now note only that, for the UAAL, longer amortization periods result in lower current contributions and a longer period before the contribution reverts to the Normal Cost. Longer periods also produce lower contribution volatility. Shorter amortization periods get to full funding more rapidly but at the price of higher current contributions and higher contribution volatility.

That leaves the question of funding policy for overfunded plans, those that have a surplus instead of a UAAL. The GASB policy structure is used by most public plans when determining contribution amounts when there is a surplus. The surplus is amortized the same way as a UAAL, except that instead of producing an amortization *charge*, there is an amortization *credit*. This means that the contribution amount is the Normal Cost *minus* an amount that will in effect spend the surplus down over the amortization period.

Unlike for UAAL, longer amortization periods now result in a lower amortization credit, and so produce a higher current contribution (but still less than the Normal Cost). Shorter amortization periods for surplus take credit for the surplus more quickly. This produces a lower contribution, but it also means a shorter period before the contribution reverts up to the full Normal Cost.

While this policy structure still reflects a funding target of 100 percent, amortizing surplus results in an annual contribution that is less than the Normal Cost. This can lead to a full or partial “contribution holiday” where contributions are less than the regular, ongoing cost of current service, especially if the surplus amortization period is relatively short. Recent history has led to a reevaluation of this condition for public pension plans.

One of the most significant changes in industry thinking and practice to come from the market experience around the turn of the 21st century is the way surplus is recognized in public pension funding policy. In many cases, short amortization periods for surplus in the late 1990s led to reductions in contributions below the level of Normal Cost, sometimes even to complete “contribution holidays” of zero contributions. As the market reversals in the early 2000s led to resumption of contributions in most pension plans, the general lesson was that a contribution level less than the Normal Cost (that is, funding the Normal Cost out of surplus) should always be viewed with caution, as ultimately the Normal Cost will reemerge as the basic cost of the plan.

One possible response would be to require that contributions never fall below the Normal Cost level. However, that would be inconsistent both with the GASB accounting standards and with the actuarial principle that funding policy should target 100 percent funding, and not sustain a level that is either higher or lower than 100 percent. That leads to the general conclusion that surplus should be amortized, but over very long periods. Note that this is consistent with the 30-year surplus amortization policy adopted by CalPERS in April 2005. That 30-year surplus amortization period is also to be found as Recommendation 7 in the Report of the (California) Public Employee Post-Employment Benefits Commission.

## **AMORTIZATION POLICY**

### ***Amortization Policy: Selection of Amortization Structure and Methods***

Setting an amortization policy involves a few policy decisions and considerations in addition to selecting the amortization periods. Here is a brief description of those issues, followed by a detailed discussion of amortization periods. That discussion includes the current LACERS policy and some possible alternatives that may be considered by the Board.

- Single amortization layer for the entire UAAL or surplus, or separate amortization layers for each source of UAAL or surplus.
- Closed (fixed) period amortization or open (rolling) period amortization.
- Level dollar or level percent of pay amortization payments.
- For separate amortization layers, when is it appropriate to “restart” or otherwise combine the amortization layers.

The current LACERS policy uses separate, fixed period amortization layers for each source of UAAL. This has the advantage of tracking separately each new portion of underfunding and identifying a date certain by which each will be funded. This is the structure required by the ERISA/IRC rules for corporate and multiemployer plans, and is increasingly common for public pension plans, especially in California.

### ***Level Dollar vs. Level Percent of Pay Amortization***

The amortization payments may be patterned in one of two ways, as a level dollar amount or as a level percentage of pay. The ERISA/IRC rules for corporate and multiemployer plans require level dollar amortization, similar to a typical home mortgage. However, by far most public plans use level percent of pay amortization where the payments increase each year in proportion to the assumed payroll growth. That means they start lower than the corresponding level dollar payments, but then increase until they are higher.

The level dollar method is more conservative in that it funds the UAAL faster in the early years. For the same reason it also incurs less interest cost over the amortization period.

The current LACERS policy uses level percentage of pay amortization. The justification for using level percent of pay payments is that it is consistent with the Normal Cost (which for pay related plans like LACERS is almost always determined as a percentage of pay) and that it provides a total cost that remains level as a percentage of pay. In contrast, level dollar amortization of UAAL will produce a total cost that decreases as a percentage of pay over the amortization period.

### ***Negative Amortization***

Unlike a level dollar amortization, under level percent of pay amortization the UAAL may increase during the early years of the amortization period even though contributions are being made to amortize the UAAL. This happens because with level percent of pay amortization, the lower early payments can actually be less than interest on the outstanding balance, so that the outstanding balance increases instead of decreases. For typical public plan assumptions (including LACERS), this happens whenever the amortization period is longer than about 17 years. This means that the outstanding balance of the UAAL does not decrease until there are 17 or fewer years left in the amortization period. It also means that the outstanding balance will not fall below the original amount until some years after that time.

Attachment 2 shows this effect for a sample UAAL layer of \$1 million under various level percent of pay amortization periods. While there is nothing inherently wrong with negative amortization, the Board should be aware of its consequences, especially for amortization periods substantially longer than 17 years.

### ***When is it Appropriate to “Restart” the Amortization Layers?***

As discussed above, the current LACERS policy uses separate, fixed period amortization layers for each source of UAAL. Under this approach, over time there will be a series of these layers, one for each year's gain or loss as well as for any other changes in UAAL. This is perfectly manageable and in fact provides a history of sources of the System's UAAL in any year. Also note that in practice the number of layers will be limited by the length of the amortization period as eventually layers are fully amortized, and so are no longer part of the series of layers.

Under the current funding policy there may be conditions where the Board would want to consider action whereby all the amortization layers are wiped out (“considered fully amortized”) and the series is restarted, for example, when the System goes from surplus to UAAL, or from UAAL to surplus. This would be done to avoid possible anomalies as well as results that might fail to comply with the GASB accounting standards.

In particular, under the layered approach, it is possible for a plan with a UAAL to nevertheless have a net amortization credit in the current year. While that result is actuarially consistent it is also very counterintuitive, since a UAAL would seem to require a net amortization charge. In fact, for that very reason this result would fail to meet a GASB requirement that a plan with a UAAL must have a net amortization charge. Both those drawbacks can be readily avoided by treating each “new” UAAL or surplus condition as the beginning of a new series of amortization layers.

The above is only one example of when the amortization layers might be restarted or combined. Another is when there are alternating years of gains and losses of relatively equal size. The Board should reserve the right to restart or otherwise combine the amortization layers whenever appropriate circumstances arise.

### ***Amortization Periods***

The UAAL amortization periods for public plans typically range from 15 to 30 years, with 30 years being the maximum allowable period under the GASB accounting standards. The amortization period should not be set so short that it creates too much volatility in the contributions yet it should not be so long that it contributes a shift of cost to future funding sources. Another consideration is how much and in what circumstances negative amortization is an acceptable consequence of using longer amortization periods.

Plans that amortize the UAAL in layers by source sometimes use different amortization periods for different sources of UAAL. Generally such plans amortize actuarial gains or losses over shorter periods (15 to 20 years or less) and UAAL changes due to assumption or method changes and plan amendments over longer periods (often the 30-year GASB limit).

The following amortization periods are currently used by LACERS:

- All UAAL on or before June 30, 2005: bases combined and reamortized over 30 years in 2005
- Actuarial gains or losses: 15 years
- Assumption or method changes: 30 years
- Plan amendments: 30 years

### ***Selection of Amortization Periods for Actuarial Gains or Losses***

For amortizing actuarial gains or losses, the current LACERS policy is comparable to the approach used in the ERISA/IRC rules for multiemployer plans and also for corporate plans prior to the 1987 overhaul of the corporate pension funding rules. However, this policy may lead to inconsistencies and even short term conflicts with the GASB 30-year standard as was the case with the Health Plan in 2006 and 2007.

As for selecting the period, here again, recent experience is instructive. By the late 1990s, as plans came close to being fully funded or even over funded there was a trend toward amortization periods as short as 10 or even 5 years. For example, in 1987, the ERISA/IRC rules for corporate plans were changed to reduce the amortization period for gains and losses from the original 15 years to 5 years. This led to rapid reductions in contributions when the large investment gains from that period were recognized over such short periods. The investment losses in the early 2000s led to similar cost increases except for public plans that lengthened their amortization periods substantially once those losses started to arise.

Based on this experience, the Board may want to balance between reducing contribution volatility by using a longer amortization period and maintaining a closer relationship between contributions and routine changes in the UAAL by using a shorter amortization period. Using a shorter amortization period also reduces or avoids negative amortization as previously discussed. Based on these three considerations we generally recommend gains and losses amortization periods in the range of 15 to 20 years.

### ***Selection of Amortization Periods for Assumption or Method Changes***

Assumption or method changes, such as a modification in the mortality assumption to anticipate an improvement in life expectancy for current active members when they retire, often include a long term remeasurement. For assumption changes, in effect, such changes take gains or losses that are expected to occur in the future and build them into the cost and liability measures today. For method changes such changes fundamentally redetermine how costs are allocated to years of service for active members. In either case the long term nature of these changes could justify using a longer amortization period than that used for actuarial gains or losses, in the range of 20 to 30 years.

### ***Selection of Amortization Periods for Plan Amendments***

While the Board's current policy is to amortize the UAAL from plan amendments over 30 years; however, recent actuarial practice has evolved to use a much shorter period. Some of the arguments for using a short period include:

- Matching the amortization period to the average future working lifetime of the active members receiving the benefit improvement
- Matching the amortization period to the average life expectancy of the retired members receiving the benefit improvement

- Considering any special circumstances that may apply to a specific benefit improvement

The first two considerations would usually lead to at most a 15 to 20-year amortization period.

Improvements covered by the last consideration would include the City's current Early Retirement Incentive Program (ERIP). In a LACERS report prepared in September 2009, staff outlined the rationales for possible amortization periods. Those amortization periods ranged from 0 years (for an immediate recognition of the entire UAAL due to the ERIP) to a period of 15 years. These different periods corresponded to various alternative periods of cost savings or benefit payments under the ERIP. We refer the Board to that September 2009 report discussion and incorporate it by reference to this report. Absent any specific study to the contrary, Segal believes a 5-year amortization period is an appropriate standing policy for any future change in UAAL due to an ERIP, based on the period of salary savings normally accomplished by the reduction in future working lifetime in a typical ERIP.

### *Amortization of Surplus*

As discussed above, one of the most significant changes in industry thinking and practice to come from the market experience around the turn of the 21st century is the way surplus is recognized in public pension funding policy. Generally, current practice is reflected in the goal of keeping contributions close to the cost of current service.

One possible response would be to require that contributions never fall below the Normal Cost level. However, that would be inconsistent both with the GASB accounting standards and with the actuarial principle that funding policy should target 100 percent funding, and not sustain a level that is either higher or lower than 100 percent. That leads to the general conclusion that surplus should be amortized over the longest permissible period of 30 years. For example, CalPERS uses a 30-year amortization period when there is a surplus. This same 30-year period can also be found as Recommendation 7 in the Report of the (California) Public Employees Post-Employment Benefits Commission.

### *Selection of Amortization Periods for Past vs. Future UAAL*

As the Board deliberates modifying the amortization periods in its current funding policy, we recommend that the Board separate the discussions between (1) the amortization of the current (past) UAAL and (2) amortization of future changes in the UAAL.

As of June 30, 2009, the UAALs for the Pension and the Health Plans were \$2,164.0 million and \$660.9 million, respectively. While these UAALs were amortized over different layers as discussed above, the net UAAL payments were roughly equivalent to a single 29-year period for the Pension Plan and a 25-year period for the Health Plan.

There are two main reasons that we would not recommend any modifications to the amortization periods for the current UAALs at this time. The first is that the single equivalent amortization periods are almost at the maximum 30-year period allowed by GASB. This means that any change to longer amortization periods would likely be overridden by the GASB rule.

Second, the amortization period for these current UAALs are closely related to the actuarial cost method and, as discussed in the next section, there are compelling near term demographic reasons for delaying a review of the actuarial cost method for the current UAAL.

***Alternative Amortization Periods for Future Changes in UAAL***

Based on the above discussions, here are some alternative sets of amortization periods that the Board may want to consider with respect to any future changes in UAAL. Please note that this part of our discussion is substantially revised from the February 19 version that was presented to the Board on February 23, 2010. However the resulting alternatives are nearly the same as before, with one change to Alternative #3.

	<u>Current Policy</u>	<u>Alternative #1</u>	<u>Alternative #2</u>	<u>Alternative #3</u>
Actuarial Gains or Losses	15	20	20	15
Assumption or Method Changes	30	20	25	30
Plan Amendments*	30	15	15	15
ERIPs	15	5	5	5
Actuarial Surplus	15	30	30	30

\* *Excluding the current 2009 ERIP that used a 15-year period.*

Consistent with the above discussion, all the alternatives use relatively short amortization periods for plan amendments and ERIPs and a long period for surplus. The alternatives differ only in their treatment of the annual gains and losses and the less frequent remeasurements of the UAAL (assumption and method changes).

Alternative 1 is based on using the same period for both gains and losses and assumptions and method changes. In effect this is the long end of the recommended range for gains and losses and the short end for assumption and method changes. If the Board decides to maintain its current practice of different periods for these sources of changes in UAAL, Alternatives 2 and 3 represent a trade-off between them.

Alternative 2 allows more volatility reduction for gains and losses but accepts some negative amortization in the early years of each such amortization. At the same time, compared to 30 years, it requires faster recognition of remeasurements of the UAAL so as to reduce the substantial negative amortization associated with 30-year amortization.

Alternative 3 is the current policy for these sources of changes in UAAL, reexamined in light of this discussion. Fifteen year amortization of gains and losses avoids any negative amortization by using a relatively short period for these annual UAAL changes that are not caused by any action by the Board or the plan sponsor. However for changes that result from a Board decision to remeasure the UAAL (i.e., assumption and method changes) the 30-year period allocates that cost to a period more comparable to the length of the plans' liabilities.

Please note that with all of the above alternatives, we are continuing to recommend that the Board maintain its current policies of using closed (fixed) amortization periods and level percent of pay amortization.

### ***Cost Impact***

It is not possible to quantify in advance the full future cost impact associated with adopting any of the alternative amortization periods simply because the System's future changes in UAAL are not yet identified. However, we can measure the effect a change from the 15-year to the 20-year amortization period for actuarial gains or losses would have on LACERS' \$2,806.4 million in unrecognized investment losses as of June 30, 2009. Over the next four valuations, such a change in the gain/loss amortization period would reduce the annual payroll cost required to amortize that \$2,806.4 million in unrecognized investment losses from 12.2% (paid for 15 years) to 9.9% of payroll (paid for 20 years).

For another illustration of cost impact, the charts in Attachments #1 and #2 compare the annual UAAL payments and the outstanding balance of the UAAL for a sample change in UAAL of \$1 million under different amortization periods.

### ***Amortization Periods for the Health Plan***

For the Health Plan, there are some assumptions and plan elements that are reviewed and changed at every valuation to reflect the more dynamic nature of the healthcare market place. These include the medical cost trend assumption and the annual premium rates for medical services. We recommend that any annual changes in those assumptions and plan elements be considered similar to actuarial gains or losses and those changes in UAAL be amortized using the period adopted by the Board for actuarial gains or losses. This means that the amortization period adopted for assumption changes would apply only to changes that result from a full experience analysis of all plan assumptions.

## **ACTUARIAL COST METHOD**

The ultimate costs (ignoring expenses) for both the Pension and the Health Plans are the actual benefits paid from the Plans, offset by actual investment income. Each year, an actuarial valuation is completed to develop an annual contribution for each Plan. The valuation uses a funding method to allocate the ultimate costs for active members to each year of service, and thus among past service, current service, and future service. As noted earlier, the cost attributed to the current year of service is the Plan's Normal Cost. The accumulated costs attributed to past service is the Plan's AAL. The Plan's annual contribution is the Normal Cost, plus an amortization amount for the Plan's UAAL.

Currently, both Plans are funded using the Projected Unit Credit (PUC) method. For comparison, the most prevalent funding method used by public plans is the Entry Age Normal (EAN) method. Please note that either method is considered a reasonable funding method under actuarial standards of practice, and both are acceptable under the GASB rules.

***Actuarial Cost Method for Current Members of the Current Pension and Health Plans***

Under the PUC method, the Normal Cost is the present value of the benefit “earned” during the year, but based on projected pay levels at retirement. For an individual member, the PUC Normal Costs increase each year (both in dollar amount and as a percentage of pay) because even though the benefit “earned” each year is constant, the present value increases as the member gets a year closer to retirement. In contrast, under the EAN method, the Normal Cost is specifically determined so as to remain a level percentage of pay over the member’s career.

It is this cost stability that makes the EAN method the preferred funding method for public plans. However, that cost stability requires higher costs for the earlier years of service.

For each member, the PUC Normal Cost starts lower than the EAN Normal Cost, and then eventually becomes higher as the member ages. This crossover occurs because the PUC method will have to make up for the lower level of contributions during the earlier years of the member’s career. For the entire plan as a whole, this crossover point depends primarily on the average age of the active members.

The crossover point where the PUC Normal Cost becomes higher than the EAN Normal Cost is also dependent on each plan’s benefit structures. Therefore, even with the same plan population, a method change from PUC to EAN can increase the Normal Cost for some plan designs and decrease the normal cost for others. That turned out to be the case for the two LACERS plans when we studied the costs of the two funding methods in October 2005. A change from the PUC to the EAN method in 2005 would have increased the Normal Cost for the Pension Plan but decreased the Normal Cost for the Health Plan.

The other key point is that, unlike Normal Costs, the AAL under the EAN method is always higher than under the PUC method. This means that, all else equal, changing from PUC to EAN may increase or decrease the Normal Cost, but will always increase the UAAL amortization cost. This is the result of, as noted above, the EAN method allocating higher costs to earlier years of service so as to produce a more stable cost pattern over all years of service.

According to the 2005 study, a switch from the PUC to the EAN method for the Pension Plan would have increased the Normal Cost and the UAAL contribution rate by about 0.6% and 1.8% of payroll, respectively.

While we can update the comparison we made in 2005 to get the results for 2009, we are not recommending such a study at this time. This is because the relationship between the costs under the two methods will depend on the net, offsetting effect of two upcoming events on the demographics of the LACERS membership: the current ERIP and any possible layoffs by the City. The ERIP will tend to decrease the average age of the remaining active membership, while layoffs would tend to increase that average age.

***Actuarial Cost Method for New Members Under Any Proposed Pension and Health Plans***

We understand that the City may be studying the costs associated with providing a new tier of benefit for new members. As part of that transition, the Board may want to consider a transition to the more stable costs calculated under the EAN method.

As an example, under a hypothetical formula that provides a 2.16% pension benefit at 67, the total PUC Normal Cost would be about 9.4% of payroll for new entrants at the current LACERS average entry age of 36 . However, at the current LACERS average attained age of 46, the cost would be about 12.3% of payroll. This means that the average cost of the new tier will increase as the new entrants age and eventually become demographically similar to the current LACERS membership.

This highlights the fact that the cost instability of the PUC method (higher costs as members age) is especially problematic for a tier that covers only new entrants, since that new entrant group will increase in average age as they eventually become more like the current active membership. In contrast, under the EAN method, the Normal Cost rates would be about 14.2% for the new entrant group average age and 13.8% for the current members' average age. For that reason, and to allow a transition to the more stable EAN cost method, we recommend that the Board consider changing to the EAN cost method for any new tier benefits.

**ASSET SMOOTHING METHOD**

As noted at the beginning of this report, in 2009, the Board conducted a comprehensive review of the asset smoothing method. As a result of that review, the Board decided to maintain its 5-year asset smoothing period but to expand the Market Value (MVA) Corridor so that the Actuarial Value of Assets (AVA) would be allowed to vary within a range of 50%-150% of the MVA.

This decision was made after detailed discussions of the impact of using a longer smoothing period in developing the AVA, as detailed our formal report dated April 23, 2009 as well as subsequent presentations. That decision was based in part on the fact that the 5-year asset smoothing period currently used by the Board is still the industry standard and is by far the most common period used by public plans. That 5-year period, in our opinion, also meets the Actuarial Standard of Practice standard of being “sufficiently short,” which allows the Board substantial flexibility in setting the MVA Corridor. For those reasons, we believe it is reasonable for the Board to continue the asset smoothing policy adopted in 2009.

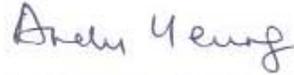
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We look forward to discussing this with you and your Board.

Sincerely,



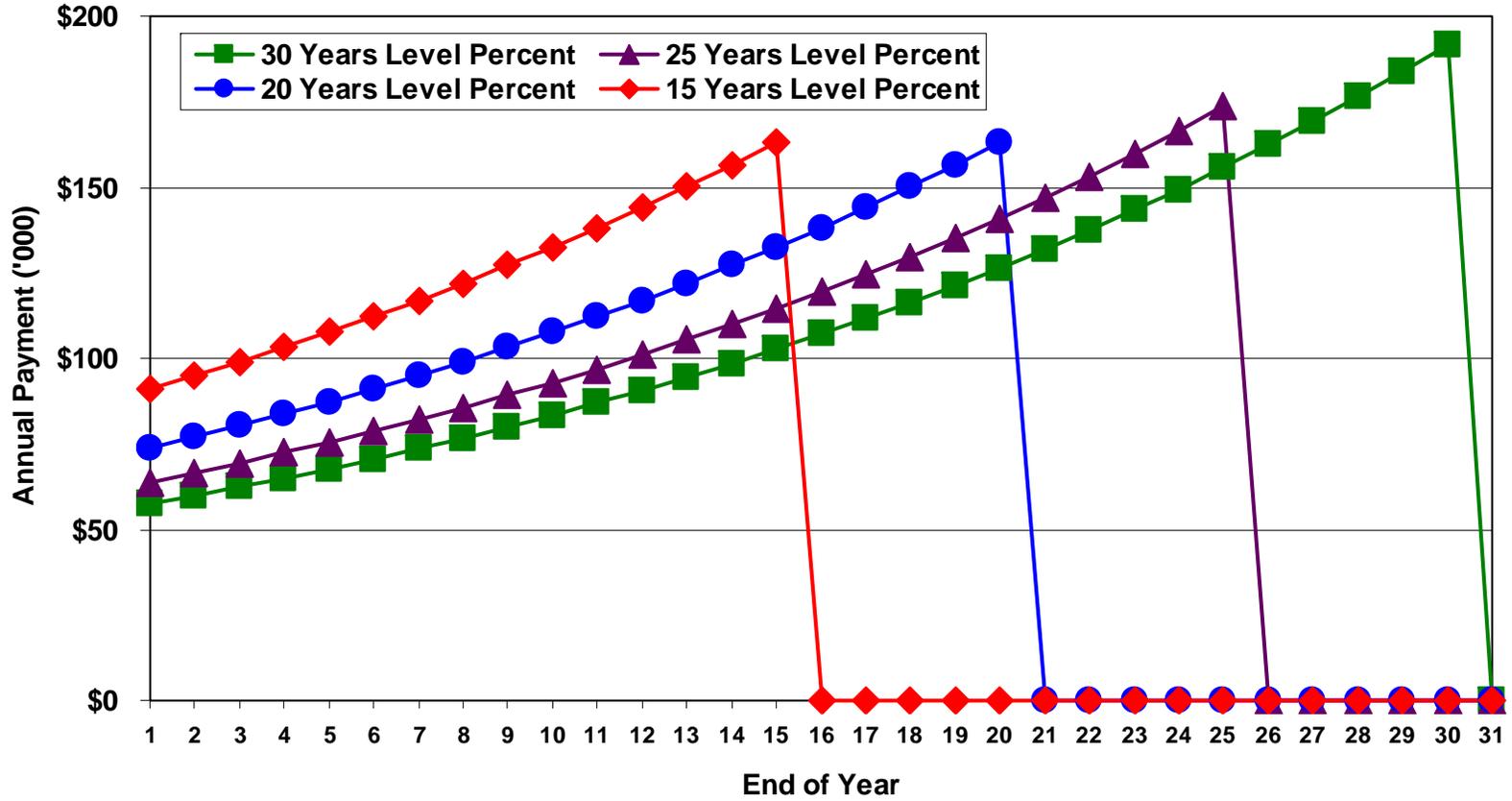
Paul Angelo, FSA, MAAA, EA, FCA  
Senior Vice President and Actuary



Andy Yeung, ASA, MAAA, EA, FCA  
Vice President and Associate Actuary

AYY/gxk  
Enclosures

Attachment #1 - Illustration of Payments Under Different Amortization Periods  
(On \$1 million UAAL)



Attachment #2 - Illustration of Outstanding UAAL Balance Under Different Amortization Periods  
(On \$1 million UAAL)

