Agenda Report

October 28, 2019

TO: Honorable Mayor and City Council

FROM: Department of Finance

SUBJECT: **REVIEW OF CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM (CalPERS) ANNUAL VALUATIONS FOR THE YEAR ENDED JUNE 30, 2018, CALPERS INVESTMENT PERFORMANCE AS OF JUNE 30, 2019, AND THE SECTION 115 PENSION TRUST**

RECOMMENDATION:

The following report is for information only. No City Council action is required.

EXECUTIVE SUMMARY:

The purpose of this report is to provide information on the status of the City's Safety and Miscellaneous pension plans with CalPERS. Payment for the pension plans is divided into two components; payment of unfunded but earned pension credit, and payment for the actuarially estimated current year service credit. The current year service cost is known as the normal cost and it is paid by employee and employer contributions. The City's total payment obligations are projected to increase every year until they initially peak in fiscal year (FY) 2024, then plateau with slower growth through FY 2031 for a second peak and subsequently decline.

BACKGROUND:

The City contracts with CalPERS to provide retirement benefits for all eligible employees. Each year the CalPERS actuarial staff perform a valuation of the City's two pension plans - safety and miscellaneous (non-safety) - to review the funding status of the plans. The valuation generally focusses on two primary cost components; the accrued liability for benefits earned but not yet paid, and the normal cost of benefits being earned in the next year.

The total accrued liability amount for each plan is compared against the market value of assets at the end of each fiscal year. Since the Great Recession, this comparison has resulted in an Unfunded Accrued Liability (UAL). The UAL represents the shortfall of the amount that should be in the fund compared to the actual amount in the fund. Based upon the most current valuation for the year ended June 30, 2018, the combined UAL of both plans was $511 million.

There are three main factors which can affect the UAL balance: 1) plan performance each year compared to all the assumptions; 2) changes to the assumptions; and 3) plan benefit changes. For the purpose of the review that is part of this report, the focus is on the plan valuation for the years ended June 30, 2016, 2017 and 2018. During this three year period, both plan performance and changes to assumptions have affected the increase in the UAL.

Unfunded Accrued Liability

	FY 2016	FY 2017	FY 2018
UAL (in millions)	$470.3	$460.2	$511.2

While the UAL has typically been referenced as a lump sum value when presented to the City Council, the UAL is comprised of dozens of individual outstanding amounts related to gains, losses and assumption changes accumulated over a period of up to 30 years. The Miscellaneous UAL is comprised of 22 individual amounts and the Safety UAL is comprised of 30 individual amounts. These amounts are itemized on page 16 of the respective valuations included in Attachments A and B.

CalPERS has developed a funding methodology for the UAL and assesses an annual required payment that the City must make in monthly installments. CalPERS does not use a level payment formula for each of the UAL amounts similar to what one might experience with a fixed rate mortgage, but instead has developed an amortization schedule designed to smooth out gains or losses. This smoothing results in an accumulation of capitalized interest for the first few years of the amortization, which makes the gain or loss increase during the first few years before the principal begins to decrease. Additionally, CalPERS currently amortizes gains or losses related to plan performance over a 30-year period, but uses a shorter 20-year period for changes to assumptions or plan benefit changes. The smoothing methodology along with the various amortization terms creates the need for increased UAL payments over the next ten years.

The UAL was positively affected with the June 30, 2018 valuation based on investment earnings of 8.6% and for the Miscellaneous Plan, the net gain above assumptions was $10,849,572. Since this valuation is used to establish the FY 2021 rates, CalPERS assumes this amount will earn interest at 7.0% for the next two years prior to being factored into the rates. Therefore, it is assumed that for FY 2021 this balance will be $12,421,675. Below are examples of the amortization schedules based on this initial principal amount. The "Default – 30 Yr, 5 Yr Ramps" table represents the current methodology for amortizing gains or losses. The "Default – 20 Yr, 5 Yr Ramps" table represents that same amount if the gain or loss had been related to an assumption change.

UAL Amortizations – 30 Year; 20 Year

Default - 30 Yr, 5 Yr Ramps			Default - 20 Yr, 5 Yr Ramps		
Balance	Period	Payment	Balance	Period	Payment
$ 12,421,675	30	$ 169,653	$ 12,421,675	20	$ 231,598
$ 13,115,702	29	$ 348,637	$ 13,051,626	19	$ 475,933
$ 13,673,168	28	$ 537,337	$ 13,472,931	18	$ 733,532
$ 14,074,463	27	$ 736,152	$ 13,657,265	17	$ 1,004,938
$ 14,298,194	26	$ 945,495	$ 13,573,757	16	$ 1,290,718
$ 14,321,040	25	$ 971,496	$ 13,188,791	15	$ 1,326,212
$ 14,318,590	24	$ 998,212	$ 12,740,162	14	$ 1,362,683
$ 14,288,332	23	$ 1,025,663	$ 12,222,403	13	$ 1,400,157
$ 14,227,561	22	$ 1,053,869	$ 11,629,637	12	$ 1,438,661
$ 14,133,360	21	$ 1,082,850	$ 10,955,549	11	$ 1,478,225
$ 14,002,586	20	$ 1,112,629	$ 10,193,350	10	$ 1,518,876
$ 13,831,855	19	$ 1,143,226	$ 9,335,747	9	$ 1,560,645
$ 13,617,522	18	$ 1,174,665	$ 8,374,905	8	$ 1,603,563
$ 13,355,666	17	$ 1,206,968	$ 7,302,411	7	$ 1,647,661
$ 13,042,066	16	$ 1,240,160	$ 6,109,226	6	$ 1,692,971
$ 12,672,179	15	$ 1,274,264	$ 4,785,649	5	$ 1,739,528
$ 12,241,123	14	$ 1,309,306	$ 3,321,262	4	$ 1,429,892
$ 11,743,644	13	$ 1,345,312	$ 2,074,659	3	$ 1,101,911
$ 11,174,098	12	$ 1,382,308	$ 1,080,060	2	$ 754,809
$ 10,526,414	11	$ 1,420,322	$ 374,884	1	$ 387,783
$ 9,794,070	10	$ 1,459,381	$ (0)	-	$ -
$ 8,970,060	9	$ 1,499,514			
$ 8,046,856	8	$ 1,540,750			
$ 7,016,371	7	$ 1,583,121			
$ 5,869,924	6	$ 1,626,657			
$ 4,598,192	5	$ 1,671,390			
$ 3,191,167	4	$ 1,373,882			
$ 1,993,393	3	$ 1,058,748			
$ 1,037,753	2	$ 725,242			
$ 360,200	1	$ 372,593			
$ -					
		$33,389,803		Sum of Payments	$24,180,295

In February 2018, the CalPERS board approved an entirely different methodology for amortizing UAL amounts that will become effective with the valuation of the year ending

June 30, 2019. These changes include reducing the amortization period from 30 years to 20 years for gains and losses and shifting from the 5 Year Ramp, also known as the smoothing amortization schedule, to a level dollar amount amortization schedule. Both of these changes will result in greater volatility of the annual UAL amounts, but will eliminate the accumulation of capitalized interest and reduce the amount of interest earned or paid over time.

The table below shows the amortization of the same $12.4 million under the approved methodology. The first year payment, or realization of surplus under the old 30-year methodology, would have been $169,653, whereas the new amount would be $1,175,196.

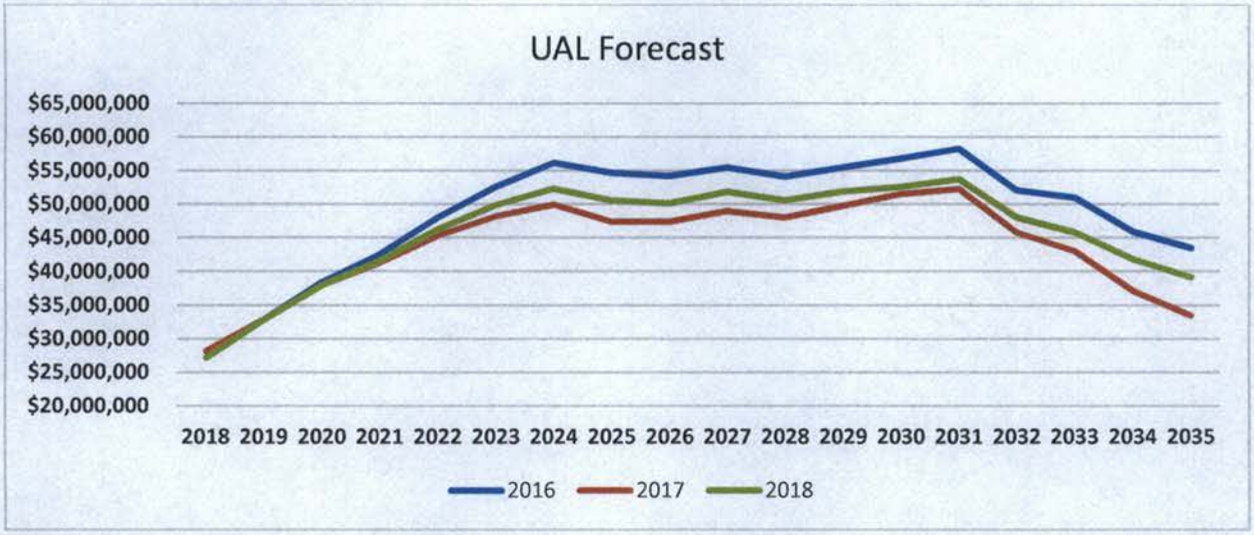
UAL Amortization Based on New Approved Methodology
(Effective Year Ending June 30, 2019)

20 Yr, Level $ Payment		
Balance	Period	Payment
$ 12,421,675	20	$ 1,175,196
$ 12,134,831	19	$ 1,175,196
$ 11,826,474	18	$ 1,175,196
$ 11,494,991	17	$ 1,175,196
$ 11,138,646	16	$ 1,175,196
$ 10,755,575	15	$ 1,175,196
$ 10,343,773	14	$ 1,175,196
$ 9,901,087	13	$ 1,175,196
$ 9,425,199	12	$ 1,175,196
$ 8,913,620	11	$ 1,175,196
$ 8,363,672	10	$ 1,175,196
$ 7,772,478	9	$ 1,175,196
$ 7,136,945	8	$ 1,175,196
$ 6,453,746	7	$ 1,175,196
$ 5,719,308	6	$ 1,175,196
$ 4,929,787	5	$ 1,175,196
$ 4,081,051	4	$ 1,175,196
$ 3,168,661	3	$ 1,175,196
$ 2,187,841	2	$ 1,175,196
$ 1,133,460	1	$ 1,175,196
$ -	-	$ -
Sum of Payments		$23,503,923

The current valuation for the year ended June 30, 2018 includes realized plan performance gains primarily due to favorable investment returns, a reduction in the assumed rate of return on investments from 7.25% to 7.0%, and methodology changes for things such as improved mortality rates. In total, the reduced rate of return and methodology changes far outweighed the positive investment earnings. For the City's two plans, the positive investment earnings provided a net benefit to the UAL as mentioned above, but the assumption and methodology changes created an additional liability of $59.1 million. As previously noted, the investment returns are amortized over a 30-year period and the assumption and methodology changes are over a 20-year period, so the payment requirements of the shorter duration have an even greater impact in the near term.

Despite the somewhat negative data from the reports, the net impact of all the actuals was better than what was initially forecasted in the year ended June 30, 2016 valuations, but worse than the June 30, 2017 report.

As shown in the chart below, the future UAL payments have reduced some over the three year period.

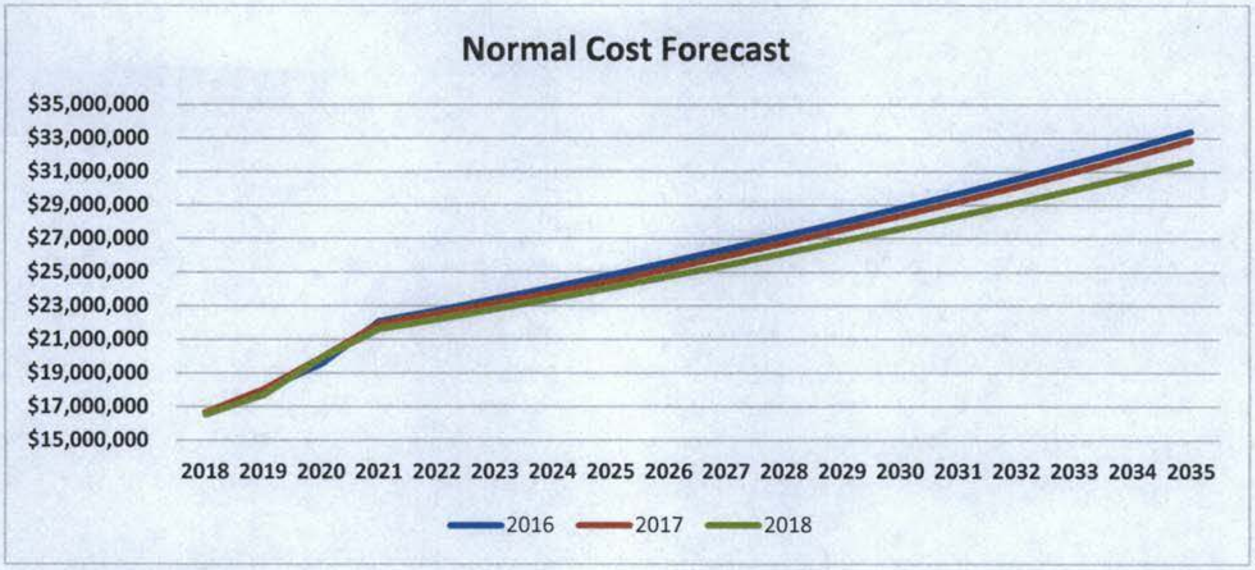


The initial forecast for this review period for June 30, 2016 was prior to positive investment returns of 11.2% and 8.6% in 2017 and 2018. While the forecast for future UAL payments has improved, it is still important to note that the FY 2020 payments total $37.98 million and are projected to increase to $53.75 million in FY 2030.

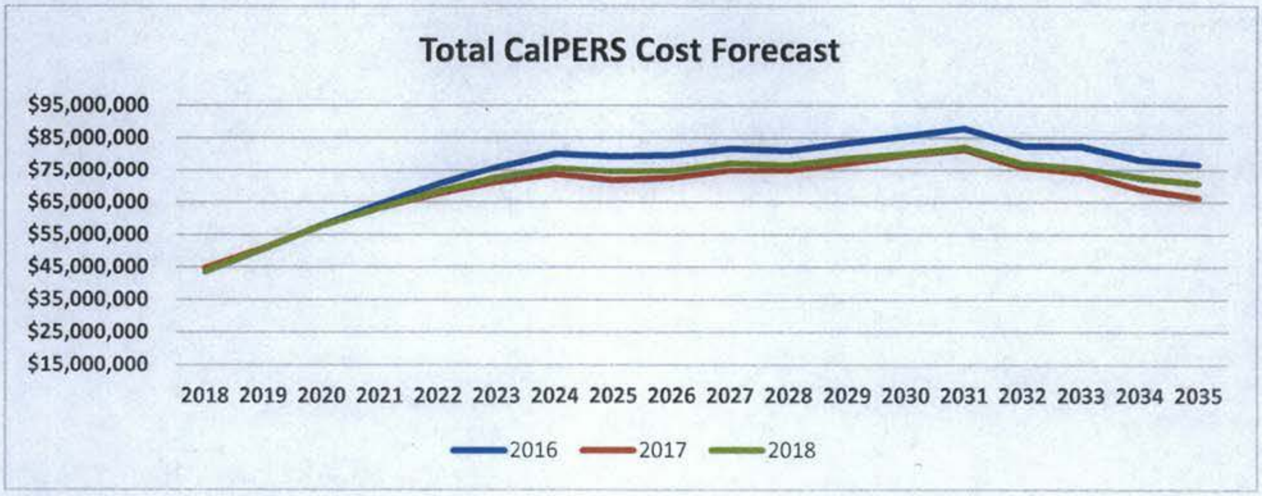
Normal Cost

The second component of the annual CalPERS rates are the normal costs. The normal cost is the amount that the City and employees each must pay assuming that CalPERS meets all of the assumptions. Stated another way, normal costs represent the portion of the cost of projected benefits allocated to the current plan year. In 2013, the Public Employee Pension Retirement Act (PEPRA) took effect and created a two-tiered pension system where all new members hired after January 1, 2013 would receive a reduced pension formula. Additionally, the normal costs for PEPRA members are adjusted annually with the intent of collecting more funds through the normal cost and less through future UAL amounts. When CalPERS reduced the expected rate of return down to 7.0% and lowered the mortality rate, it resulted in an increase to the normal cost for both Classic and PEPRA employees. As such, the normal cost for Classic Miscellaneous members in FY 2016 was 8.0% and increases to 10.0% in FY 2021 as a percentage of regular pay. PEPRA Miscellaneous normal cost will have increased from 12.5% to 13.85% in the same period. For Classic Safety members, the normal cost will have increased from 17.1% to 19.9% and for PEPRA members from 22.3% to 25.0%.

CalPERS assumes annual payroll growth of 2.75%; therefore, even if the normal cost rate remained level in the future, the normal cost contribution is expected to steadily increase each year. The steeper increase from 2018 to 2021 is related to the phased-in increase of the normal cost to the higher percentages. The fact that the projection is lower in FY 2018 as compared to 2016 is a reflection of actual payroll growth being lower than originally forecasted, largely due to the elimination of vacant positions in prior years and CalPERS reducing its payroll growth assumption from 3.0% to 2.75%.



Previously, when CalPERS obligations have been presented to the City Council as part of the annual budget process, the totals have included both the UAL and normal costs. A comparison of the combined totals is provided in the following chart.



The peak forecast from the 2016 valuation was $87.94 million and, as of the 2018 valuation, it is $82.10 million. As shown in the chart above, the steepest increases have occurred in the past few years and will continue through FY 2024. In FY 2025, some components of the UAL will be paid off, temporarily reducing the total payment and should result in more modest increases from FY 2026 through 2031.

CalPERS Investment Performance as of June 30, 2019

CalPERS published its investment returns for the Public Employees Retirement Fund earlier this summer. For the year ended June 30, 2019, the fund had a net return (after fees) of 6.7%, slightly missing their target return of 7.0%. For the 3-year period their net return is 8.8%, the 5-year net return is 5.8%, and the 10-year net return is 9.1%. While the 3 and 10-year returns are certainly positive in terms of beating the target, it is important to note that all of the previous gains and losses have already been accounted for in the UAL and the most recent year's loss has not. Therefore, the UAL will increase once the 0.3% loss is factored into the figures and the amount will be amortized using the newly approved, 20-year level payment methodology.

Section 115 Pension Trust

In June 2017, the City Council approved the establishment of a Section 115 Trust to set aside funds to help offset future pension obligations. At that time the City Council authorized a deposit of $10.0 million from the General Fund's fund balance and subsequently later in 2017 authorized another contribution of about $500,000. As of June 30, 2019, the balance increased to $11,230,935 through investment returns. These funds can only be used to offset pension obligations and may be drawn down at any time through City Council action. While the City Council has not adopted a formal future spending plan for these funds, it is anticipated that they will be held for the near term of at least five years as additional financial protection in the event of a recession, disaster, or other pressing financial needs from the General Fund. Additional options for use could include paying down a portion of the UAL to reduce amortization length or for offsetting future investment losses by CalPERS to prevent the UAL from increasing further.

<u>COUNCIL POLICY CONSIDERATION</u>:

The City Council's strategic planning goal of maintaining fiscal responsibility and stability will be advanced by the commitment of General Fund Balance for Emergency Contingency.

FISCAL IMPACT:

There is no action being recommended; therefore, there is no direct fiscal impact.

Respectfully submitted,

MATTHEW E. HAWKESWORTH
Director of Finance

Approved by:

STEVE MERMELL
City Manager

Attachments: (2)
1) Attachment A – CalPERS Miscellaneous Valuation - June 30, 2018
2) Attachment B – CalPERS Safety Valuation – June 30, 2018