Agenda Report

July 20, 2020

TO: Honorable Mayor and City Council

Through: Finance Committee (July 9, 2020)

FROM: City Manager

SUBJECT: **RECENT ACTIONS BY CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM REGARDING INVESTMENT STRATEGIES AND GOVERNING BOARD STRUCTURE**

RECOMMENDATION:

It is recommended that the City Council:

1. Find that the proposed action is categorically exempt from the California Environmental Quality Act (CEQA) pursuant to State CEQA Guidelines Section 15061 (b)(3) the general rule that CEQA only applies to projects that may have an effect on the environment; and

2. Authorize the City Manager to work with other cities to send a letter to California Public Employees Retirement System (CalPERS) recommending against actions to increase the overall risk to its investment portfolio; and

3. Recommend that the City engage local State Legislators to pursue changes to CalPERS governance including the Board structure and increased transparency.

EXECUTIVE SUMMARY:

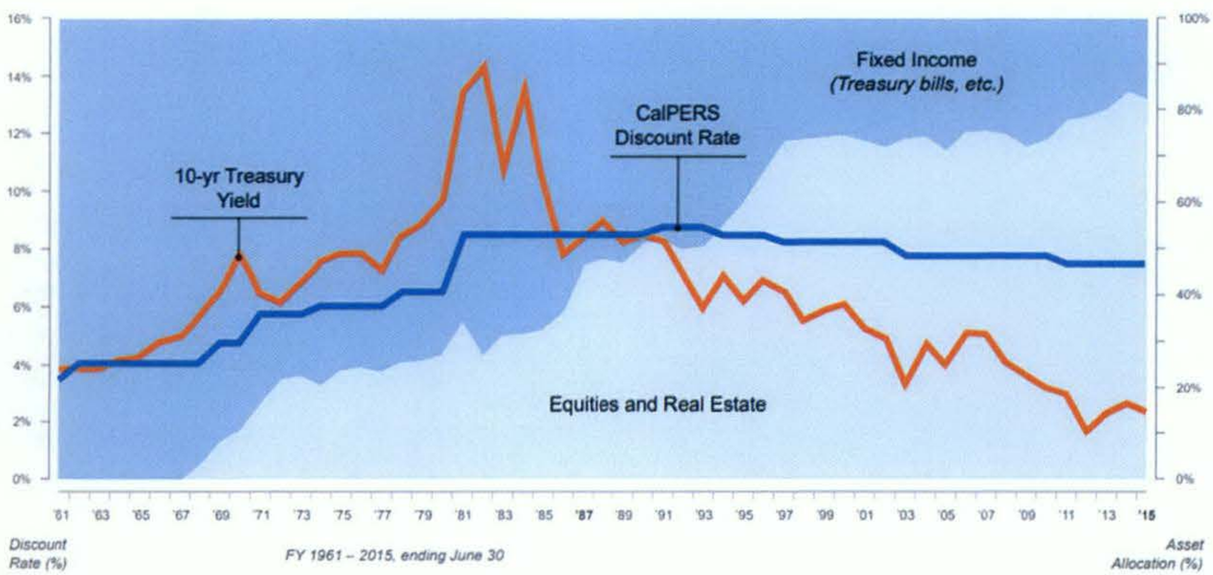
The Finance Committee met on July 9, 2020 to review this item. The Committee modified staff's original recommendation to include collaboration with other cities to send a joint letter to CalPERS regarding concerns of increased risk in the portfolio, and to engage local State Legislators regarding CalPERS governance and transparency.

CalPERS has made a number of changes reducing transparency and taking on additional investment and plan risk without involving member agencies. It is recommended that the City work with other cities to send a letter and engage our State Representatives requesting action. Actions should include requirements to inform, collaborate with and educate member agencies prior to changes in the Investment

Strategic Plan, seek greater representation for member agencies on the Board and sub-committees, and remove authority to meet in closed session on any matters related to investments or investment strategies.

BACKGROUND:

The pension plan or pension fund is the largest financial investment for most public agencies. For many cities in California, those funds are managed by CalPERS. Pasadena had almost $1.3 billion in assets with CalPERS as of the latest valuation dated June 30, 2018. For roughly the first 35 years of CalPERS' operation, they followed the three guiding public finance principles of safety, liquidity and yield, and sought a modest investment return or discount rate of 4% with investments in low or no-risk fixed income strategies such as Treasury Bills. Beginning in the 1960's and continuing over the course of decades, CalPERS slowly increased their discount rate, which reduced costs for member agencies while taking on more risk in the portfolio. For the following five or ten-year periods CalPERS had been able to maintain this effort, by spreading gains or losses in the plan over a longer period of time, they continued to increase investment risk, but provided stable rates. As the yield on fixed income investments began to decline in the early 1980's, CalPERS doubled down on their riskier investments in equities and real estate, in the continued pursuit to meet the discount rate that had increased from 4% to 8%.



Their increased risk strategy came crashing down during the Great Recession in 2008 when CalPERS lost 23.4% of the portfolio or $97 billion. As cities were struggling to balance budgets due to losses in revenues, CalPERS was exponentially increasing the costs to member agencies to recoup investment losses and remain financially sound.

Over several years, including the adoption of the Public Employees' Pension Reform Act (PEPRA) in 2013, CalPERS adopted a number of new strategies including reduced retirement benefits for new employees, greater cost sharing between the employer and the employee, and concerted efforts to increase, but stabilize rates by reducing the discount rate over time. CalPERS reduced the discount rate to 7% and implemented provisions that would continue to lower the rate even further based on favorable market conditions. While this plan would increase costs for member agencies for at least the next twenty-years, CalPERS stressed that the benefits would outweigh the additional costs. Those benefits included:

- Strengthens long-term sustainability of the fund to pay promised benefits.
- Reduces negative cash flow; additional contributions will help offset growing pension payments.
- Reduces the long-term chances of falling below a 50% or 60% funded status that would weaken the sustainability of the fund.
- Reduces the risk of contribution increases in the future from volatile investment markets.

Despite the above changes implemented by CalPERS, member agencies have continued to share concerns regarding rising pension costs, challenges with balancing budgets locally, and looking at all opportunities to mitigate costs. Since 2017, member cities have been playing the leverage game and taking on arbitrage risk by issuing more than $1.5 billion in pension obligation bonds (POB) to pay down or off-set their Unfunded Accrued Liability with CalPERS. These cities have taken the risk in hopes of paying less in interest on the POB debt assuming CalPERS hits their investment target of 7.0%. The unfortunate reality, is that pension costs are growing each year and cities across the state are challenged more each year to allocate funding. Cities have approved the issuance of POB debt as a way to smooth out payments, extend payment terms or provide stability if CalPERS can attain their target return. However, the City of Pasadena knows all too well regarding the risks involved in issuing pension obligation bond debt for investment purposes.

In recognition of CalPERS' continued challenge to meet their 7% target, the CalPERS Investment Committee met in closed session on June 15, 2020 to discuss a new investment strategy involving increased investments in private assets. Unfortunately, California Government Code Section 11126 provides CalPERS with the ability to meet in closed session to discuss investment decisions. Following the closed session, Chief Investment Officer (CIO) Ben Meng, in open session, provided an overview regarding the new strategy of focusing on what he called "better assets" and "more assets."

CIO Meng stated, "CalPERS must diversify and increase exposure to private assets, such as private equity and private credit." He stated that private equity and credit are "better assets" because they have the potential for higher returns with a lower expected volatility when compared to publicly traded assets. CIO Meng used the term "better assets" because of the greater opportunity to earn larger investment returns, but that term seems to mask the risk and potential cost to the retirement plan and members. Additionally, the term "better assets" is not a generally accepted or recognized term for private equity and credit. This is a term that CIO Meng chose to use, likely to help build support for the increased risk by the plan.

The term "more assets" is CalPERS' plan to "thoughtfully utilize a moderate level of leverage as a tool to increase the base of the assets generating returns in the portfolio." In short, CalPERS will take on investment risk by borrowing at current low interest rates and reinvesting in securities with the hope to generate investment income that will exceed borrowing cost. At a moderate level of leverage, the CalPERS Board is allowing leverage of up to 20% of the portfolio, which equates to $80 billion on a $400 billion plan. It should also be noted, that the better assets and more assets plans will operate independently of each other, so the leveraging or borrowing to invest could be used to acquire any type of investment in the pool. CIO Meng also acknowledged in his presentation that, "leverage can exacerbate some short-term volatility." This seems to be in contradiction with the fourth bullet provided by CalPERS when they reduced the discount rate regarding reduced contributions due to less volatility. Leveraging is basically taking additional risk to augment investment returns in a portfolio and works best when markets are positive. It can be devastating and creates magnified losses when markets experience negative returns.

As noted in the chart at the beginning of this report, CalPERS has been assuming additional risk for decades to meet higher discount rates and reduce costs to member agencies. The question for member agencies as a whole is, how much risk is too much? Cities are not united on the answer to this question and many care far more about the annual pension costs and the impact on their budgets. That statement is supported by the fact that more than $1.5 billion in POB debt has been issued by member cities in the last couple of years.

If Pasadena and other member agencies want to hold CalPERS more accountable and have a greater voice, changes need to be made to their governance structure, the State's Government Code, and the Public Employees' Retirement Law. The State Government Code provides CalPERS and their Board with autonomy and that autonomy means that member agencies have virtually no voice beyond a public comment at a meeting.

In August 2019, the CalPERS' Board of Directors voted to restructure their governance model and reduced the number of annual board meetings from nine to six. Additionally and more importantly, they also restructured the investment committee. Through 2019 the investment committee met nine times per year and was comprised of the entire Board of Directors with decision making ability. The approved changes reduced the investment committee to a subcommittee of the Board with only nine members, no decision making powers, and reduced the number of annual meetings from nine to four. At a time when local governments and other public agencies are becoming more transparent, CalPERS moved in the opposite direction.

Pasadena's contracts with CalPERS state that investment responsibility belongs to CalPERS under the guidance of the California Public Employees' Retirement Law. As such, member agencies have no recourse or means to hold CalPERS accountable to decisions, policies or investment strategies they undertake. As a first step in seeking change, it is recommended that the City work with other cities to send letters and engage our State Representatives requesting action. Actions should requirements to inform, collaborate with and educate member agencies prior to changes in the Investment Strategic Plan, seek greater representation for member agencies on the Board and sub-committees, and remove carte-blanche authority to meet in closed session on any matters related to investments or investment strategies.

Attached are several articles regarding pension plan funding and the recent decisions by CalPERS to increase Private Asset investments and leverage of the portfolio.

FISCAL IMPACT:

The City expected CalPERS costs for Fiscal Year (FY) 2021 to exceed $63 million and they are projected to increase to more than $86 million by FY 2031. All policy and investment decisions made by the CalPERS Board of Directors have serious impacts on the City of Pasadena's current and future financial well-being. It is important that the City take a proactive role in ensuring CalPERS operates in the best interest of its members and member agencies.

Respectfully submitted,

MATTHEW E. HAWKESWORTH
Director of Finance

Approved by:

STEVE MERMELL
City Manager

Attachments:

A – Financial Times Article – Pension funds and private equity: a puzzling romance
B – Bloomberg Article – Peak Private-Equity Fears are Spreading across Pension World
C – BuyoutsInsider.com – CalPERS CIO unveils major new leverage-backed push into private equity and private credit