Staff Report

TO: City Council

FROM: Jennifer Ustation, Finance Director

DATE September 21, 2021

SUBJECT: **CalPERS Pension Update**

Background and Analysis:

On March 3, 2020, the City Council received a presentation from Bartel Associates, LLC regarding the June 30, 2018, Valuation Preliminary Results. This presentation has been included as Attachment A. This report outlined that pension costs are very likely to increase and outpace revenue growth over the next twelve years. It is also projected that a recession coupled with growing needs is expected to create budget deficits by FY2024. This staff report continues the discussion and looks for direction from the City Council.

Pension Costs Overview

One of the costs that is projected to outpace revenue growth is pension costs. Pension costs for the City are divided into two categories (1) normal costs and (2) unfunded liability as follows:

Normal Costs - This is the cost associated with existing employees and is computed as a percentage of wages, and

Liability Costs - This is the cost associated with past and current employees where the estimated cost of future retirement benefits exceeds the amount of funds available in the system to pay those benefits.

Each year the City submits payments to CalPERS for each of the normal costs and the liability costs.

There are two major inputs into the pension system that is managed by CalPERS. This includes (1) the pension contributions made by the City/Employees into the system (for both normal costs and the unfunded liability), and (2) the investment returns those funds generate.

An unfunded liability is created when the contributions and/or investment returns are insufficient to pay for the projected cost to employees when they retire. The primary driver of the current liability is the lack of sufficient investment returns.

CalPERS Discount Rate and its Effects on Pension Funded Status

The discount rate is the long-term interest rate used to fund future pension benefits. It is one of the key components of the Asset Liability Management (ALM) cycle that CalPERS uses to balance assets with future pension obligations. The discount rate is also known as the assumed rate of return because it is what CalPERS expects its investments to earn during the fiscal year.

The overall financial health of the employer's plan is measured by the plan's funded status. The funded status represents the funded market of the assets minus the discounted value of the future liabilities. When the discount rate is reduced, it decreases the funded status because the future liabilities have less discounting as they go out into the future. Therefore, when the discount rate is reduced the costs to the City will increase.

City of Beaumont's Pension Status

The FY2020 Financial Statement Audit shows the City with a total proportionate share of the Net Pension Liability for the plan at $18,207,382, which was calculated utilizing the CalPERS 7.15% discount rate set by them as of June 30, 2020. Also within the audit was a determination of the impact that changes to the discount rate would have on the City's net pension liability. It models the effects of a 1% decrease and 1% increase to the discount rate. The effect of a 1% decrease would put the City's liability at $28,857,047 while an increase of 1% would decrease it to $9,450,732.

	Discount Rate -1% (6.15%)	Current Discount Rate (7.15%)	Discount Rate +1% (8.15%)
Miscellaneous	$ 12,019,831	$ 7,438,139	$ 3,656,276
Safety	$ 16,837,216	$ 10,769,243	$ 5,794,456
Total	$ 28,857,047	$ 18,207,382	$ 9,450,732

The estimated balance for the City's proportionate share of the pension liability for FY2021 is below.

	Discount Rate -1% (6.15%)	Current Discount Rate (7.15%)	Discount Rate +1% (8.15%)
Miscellaneous	$ 13,128,862	$ 8,214,777	$ 4,154,423
Safety	$ 18,254,588	$ 11,725,412	$ 6,367,605
Total	$ 31,383,450	$ 19,940,189	$ 10,522,028

Below shows the estimated increase in the liability from FY20 to FY21

	Discount Rate -1% (6.15%)	Current Discount Rate (7.15%)	Discount Rate +1% (8.15%)
Miscellaneous	+ $1,109,031	+ $ 776,638	+ $ 498,147
Safety	+ $1,417,372	+ $ 956,169	+ $ 573,149
Total	+ $2,526,403	+ $1,732,807	+ $1,071,296

CalPERS Funding Risk Mitigation Policy and ALM Process

CalPERS recently triggered its Funding Risk Mitigation Policy when it reported preliminary investment returns of 21.3%. This policy lowers the discount rate in years of good investment returns. This is the first time this policy has been triggered. CalPERS is also in its Asset Liability Management (ALM) process which was put into place by the CalPERS Board to strengthen long-term pension fund sustainability. This policy runs on a four-year cycle with a mid-cycle review after two years. The full review is taking place now.

Application of the CalPERS Funding Risk Mitigation Policy has reduced the discount rate to 6.8% going into the ALM review process. The full effect of this discount rate change will be felt by the City in FY2024. On September 13, 2021, the CalPERS board was presented with candidate portfolios with proposed discount rates. A look at portfolio candidates that were presented to the board are below.

Portfolio	**Discount Rate**	**Projected Return**
Current Portfolio: status quo	6.25%	6.2%
Candidate Portfolio A	6.375%	6.4%
Candidate Portfolio B	6.75%	6.8%
Candidate Portfolio C	6.75%	6.8%
Candidate Portfolio D	6.75%	6.8%
Candidate Portfolio E	7.0%	7.0%

These portfolio candidates all range from a low diversification to a more diversified portfolio. Some of the candidate portfolios would require CalPERS investment policy changes and a few of the candidates also include leverage as a part of the portfolio. The final decision on the portfolio candidates will be made by the CalPERS Investment Committee in November 2021.

Future Contribution Sustainability

The sensitivity of the plan as outlined above shows that the discount rate that is applied by CalPERS can greatly impact the City's employer contribution rates. Normal payroll increases also contribute to pension increases. With budget deficits projected for future years it is imperative to prepare strategies that allow the City to meet these increased costs while minimalizing the impacts to service delivery and maintaining fiscal sustainability.

The City Council has taken some steps to address this. On March 16, 2021, the City Council $2,500,000 of unassigned fund balance in the General Fund and to bring back options at a later date for a use of these funds. Beginning in FY2020, the City also started to pay its annual UAL payment upfront in July rather than paid monthly to save on interest costs. In FY2022, paying the upfront portion of the UAL payment saved the city $49,594 in interest costs.

Options to Address Future City Pension Contributions

Keep funds in committed status in General Fund reserve funds.

Pros	**Cons**
Most flexible – can be accessed for other uses	Fixed income investing only
Can be included in calculation of reserve requirement per City's policy	Unprotected from creditors and other spending pressures

115 Pension Trust

Pros	**Cons**
Fixed Income and diversified equity strategies	Irrevocable (for non-pension expenses)
Can be tailored for short or long-term use	
Exclusive benefit/protected from creditors	
Dedicated solely for pension costs	

Additional Discretionary Payments (ADPs) to CalPERS

Pros	Cons
Could have best long-term investment return	Irrevocable decision
	Extra payments cannot be used as future "credit"
	PEPRA prevents contributions from dropping below normal cost
	Still subject to CalPERS investment losses/gains policies and discount rate changes

"Fresh Start" to restructure UAL amortization payments (requires a contract amendment)

Pros	Cons
Less interest and lower long -term payments	Higher short- term payments
	Likely cannot revert to old amortization schedule
	Still subject to CalPERS investment losses/gains policies and discount rate changes

Pension 115 Trusts are a great way to invest funds specifically for pension obligations. However, not all trusts are the same as there are more than 100 established trusts, mostly since 2015. Some of the providers include PARS, PFM and Keenan. Beginning on July 2019, CalPERS started offering the California Employers' Pension Prefunding Trust (CEPPT) effective July 2019. Below are the comparisons between a supplemental trust vs CalPERS.

Supplemental Trust	CalPERS
Flexible	Locked In
Likely lower long-term return	Likely higher long-term return
Investment strategy choice	No investment choice
Does not reduce net pension liability for GASB reporting	Reduced net pension liability for GASB reporting
More visible	More restricted

City staff seeks direction from the City Council to research supplemental 115 pension trust options, consider the CalPERS pension trust, or consider any of the other options that have been listed above. The City Council can also opt to do a combination of the above to address future pension costs.

Fiscal Impact:

The cost to prepare this staff report is estimated to be $1,218.

Recommended Action:

Discuss the pension liability and its impacts on the budget in future years,
Discuss options to address the liability and projected escalation in pension costs, and
If there is interest to further consider options to address pension costs, provide guidance to staff.

Attachments:

A. Pension Cost Analysis dated January 16, 2020 – Bartel Associates, LLC