**TOWN OF LOS GATOS**

**FINANCE COMMISSION REPORT**

MEETING DATE: 12/12/2022

ITEM NO: 4

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| DATE: | December 7, 2022 |
| TO: | Finance Commission |
| FROM: | Laurel Prevetti, Town Manager |
| SUBJECT: | Receive CalPERS 2022 Annual Review of Funding Levels and Risks |

RECOMMENDATION:

Receive CalPERS 2022 Annual Review of Funding Levels and Risks.

BACKGROUND:

Staff routinely monitors items presented to the CalPERS Investment Committee and Board of Administration. While the Town has no fiduciary control over the investment decisions determined by CalPERS it is prudent to understand the potential risks, and consequences, inherent in actions taken by CalPERS. Attachment 1 contains the CalPERS 2022 Annual Review of funding levels and risks. This report focuses on:

- Reporting the current funded status of the system,
- Identifying and quantifying investment risks,
- Examining other system risks, such near-term high inflation and the COVID pandemic, and
- Discussing risk mitigating activities for the system and employers

This report is intended to assist the CalPERS Board of Administration, participating employers, and other stakeholders in assessing the soundness and sustainability of the Public Employees' Retirement System for ongoing pension plans. The results presented in this report are based on the June 30, 2021 annual valuations, which have been projected forward to June 30, 2022 based on preliminary investment performance for the year ending June 30, 2022. Staff routinely utilizes information from CalPERS during development of the Proposed Operating Budget, Five-Year Forecast, and other Town financial analysis. The Pension OPEB Oversight Committee will receive this same information at its December 20th meeting.

PREPARED BY: Arn Andrews
Assistant Town Manager

Reviewed by: Town Manager, Town Attorney, and Finance Director

DISCUSSION:

Following are items of note identified in the report:

With the lower-than-expected investment returns for Fiscal Year (FY) 2021/22, the funded status of the system is projected to decrease from 81.2% as of June 30, 2021 to an estimated 72% as of June 30, 2022. Employer contribution levels are expected to increase in response to the investment loss for FY 2021/22.

Many CalPERS plans are less than 100% funded as of June 30, 2022. CalPERS believes this is not a significant cause for concern provided employers continue to make the actuarially determined required contributions. The report states there is no specific funded status that indicates a retirement plan and its members are in jeopardy, but states plans that fall below 50% would likely have short-term required contributions that would strain the employer's budget.

CalPERS completed an Asset Liability Management (ALM) process in November 2021 that reviewed updated capital market assumptions and based on that review adopted a revised strategic asset allocation. Based on the ALM results, the discount rate was reduced to 6.8% along with a reduction in the inflation assumption to 2.3% and an increase in the payroll growth assumption to 2.8%.

CalPERS cautions that recent and current increases in the Consumer Price Index (CPI) are expected to have a material impact on the pension liabilities in future actuarial valuation reports for both retirees (due to cost of living increases) and the active members (due to future salary increases). If current inflationary trends continue, CalPERS has determined that required contributions may increase 5%-12% of payroll over the next several years depending on how long the high inflation period lasts and how quickly it returns to Federal Reserve targets.

CalPERS concludes the report with the following observation:

"Over the last few years various external factors have had material impacts on the experience of the Retirement System. While some of the impacts may have led to short-term improvements in the current funding levels of the system, other factors have worsened the funded position and pose additional threats to the system in the future.

"Recent factors that were favorable to the funded status of the system were:

- Significant investment gains during the 2020-21 fiscal year
- Higher than expected mortality likely due to the COVID pandemic

"Factors that were unfavorable to the current funding levels of the system and pose potential future threats are:

- Significant investment losses during the 2021-22 fiscal year
- Financial strain on employers due in part to the COVID pandemic
- High levels of inflation over the last 1-2 years which may persist
- Potential ongoing effects of COVID

DISCUSSION (continued):

- Potential economic downturn in the near-term
- Reduced expectations of future investment returns

"The combined impact of the above factors has the potential to worsen the funded status of the system and result in large increases to required contributions for employers and members. The ability of employers to continue making required contributions to the system is the area of greatest concern.

"While certain external factors are outside of the control of the system, CalPERS and its participating agencies have responded to these risks in a number of positive ways such as:

- The recent adoption of new amortization policies that mitigate the risk of the system dropping to dangerously low funding levels.
- The increased level of additional contributions made by CalPERS agencies.
- The use of a separate 115 trust by many CalPERS agencies for minimizing the risk of required contribution spikes and volatility.
- The adoption of a new investment policy which maintains favorable investment return expectations and associated volatility.
- Improvements in the processes of setting actuarial assumptions which are expected to lead to less volatile contributions rates in the future.
- Improved modeling tools that allow CalPERS and its participating employers to forecast future required contributions and funded status under a variety of possible future scenarios.

"In addition to the actions listed above, we believe the following items should receive a high level of focus going forward.

- Continual focus on the acceptable level of investment risk versus the desire for higher investment returns including the possible impacts of the existing Funding Risk Mitigation Policy.
- Monitor the effectiveness of the current investment policy to ensure desired returns relative to the chosen level of risk.
- Continue the focus on educating participating employers on the risks facing the system and providing tools that enhance their ability to manage these risks.
- Stakeholder outreach regarding employers' ability to make required contributions.

"With the anticipated increases in required employer contributions, due primarily to the investment losses experienced during the 2021-22 fiscal year, combined with current economic difficulties caused by the pandemic, inflation, and turbulent investment markets, some employers will likely have difficulty making required CalPERS contributions over the next several years. In addition, near-term forecasts by investment and economic professionals suggest it may be difficult to achieve a 6.8% investment return in the near-term. This potential for further increases to required employer contributions increases the risk that individual

DISCUSSION (continued):

agencies may struggle to make required CalPERS contributions leading to potential contract terminations and possible benefit reductions. While financial necessity policies within the CalPERS amortization policy can be used in some cases to spread amortization payments over a longer period and hence reduce near-term contributions, these policies require minimum contributions that may still pose challenges for some agencies. In addition, these policies do not reduce costs but merely delay and increase them. CalPERS and its participating employers have taken many positive steps to manage the risks of the system. Continued focus on the risks described in this report, and opportunities to minimize and manage them, will be of utmost importance going forward."

Attachments:

1. CalPERS 2022 Annual Review of Funding Levels and Risks