



TOWN OF LOS GATOS
TOWN PENSION AND OPEB TRUSTS
OVERSIGHT COMMITTEE REPORT

MEETING DATE: 12/05/2023

ITEM NO: 5

DATE: November 27, 2023
TO: Town Pension and OPEB Trusts Oversight Committee
FROM: Laurel Prevetti, Town Manager
SUBJECT: Receive a Report of the CalPERS 2023 Annual Review of Funding Levels and Risks

RECOMMENDATION:

Receive a report of the CalPERS 2023 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 as a fiduciary to understand the potential risks and consequences inherent in actions taken by CalPERS. Attachment 1 contains the CalPERS 2023 Annual Review of Funding Levels and Risks. This report focuses on:

- Reporting the current funded status of the system,
- Reviewing prior and expected future funding progress,
- Identifying and quantifying investment risks,
- Examining other system risks, such as high inflation and mortality, 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, 2022 annual valuations, which have been projected forward to June 30, 2023 based on investment performance of 6.1% for the year ending June 30, 2023. Staff routinely utilizes information from CalPERS during development of the Proposed Operating Budget, Five-Year Forecast, and other Town financial analysis. The Finance Commission will receive this report at its December 11th meeting.

PREPARED BY: Gitta Ungvari
Finance Director

Reviewed by: Town Manager, Town Attorney, and Assistant Town Manager

DISCUSSION:

Following are items of note identified in the report regarding CalPERS as a whole and its funding level of risk:

With the slightly lower-than-expected investment returns for fiscal year (FY) 2022-23, the funded status of the system has increased modestly from 70.9% as of June 30, 2022 to an estimated 72% as of June 30, 2023 as a result of employers making their unfunded accrued liability (UAL) payments. Funded ratios vary somewhat among the different plans, with the plans for miscellaneous members generally having higher funded ratios than plans for safety members.

Many CalPERS plans are less than 100% funded as of June 30, 2023. 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 says plans that fall below 50% would likely have short-term required contributions that would strain the employer's budget.

All actuarial assumptions and methods are based on the latest Asset Liability Management (ALM) process and associated Experience Study. These include a discount rate of 6.8%, an inflation assumption of 2.3%, and a payroll growth assumption to 2.8%.

CalPERS cautions that recent and current increases in the Consumer Price Index (CPI) are expected to have an 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). While there is no immediate concern regarding the system's ability to pay required benefits, the possibility of unfavorable events in the near future, such as continued high inflation and the possibility of an economic recession, lead to concerns that required employer contributions could rise to levels that would be challenging for employers.

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. These include extreme investment experience (both favorable and unfavorable), a global pandemic and historically high levels of inflation. In addition, over the last 10-years the system has had to recognize investment losses and significantly lower levels of future expected investment return due primarily to lower capital market assumptions across most asset classes. Also, during this 10-year period however, employer costs were somewhat reduced due to the impact of PEPRAs.

DISCUSSION (continued):

“The combined impact of the above factors has resulted in increased required employer contributions and only modest improvements in the funded status of the system over the last 10-years. However, necessary changes to actuarial assumptions over the last decade have positioned the system to see greater improvements in funded status over the next 10-years.”

Employer contributions are currently at relatively high levels due to large amounts of UAL and are projected to increase somewhat over the next 5 years. In addition, uncertainty within the economy suggests a near-term economic recession is a possibility. The ability of employers to continue making required contributions to the system is the area of greatest concern. “ Los Gatos budgets for its payments and is expected to make all required contributions if not also Additional Discretionary Payments (ADP).

Various strategies and actions by CalPERS, its Board of Administration, and its employers have improved the sustainability of the system and mitigated certain risks. Among these identified by CalPERS are:

- The adoption of the current 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 continued improvements in investment policies which maintains favorable investment return expectations and associated volatility.
- 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, CalPERS intends to give a high level of focus to the following:

- Continue the focus on the acceptable level of investment risk versus the desire for higher investment returns.
- 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.
- Conduct stakeholder outreach regarding employers' ability to make required contributions.

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DISCUSSION (continued):

According to CalPERS, it and its participating employers have taken many positive steps to manage the risks of the system. Increased focus on these risks and opportunities to minimize and manage them, as discussed in the report, are important going forward.

Attachment:

1. CalPERS 2023 Annual Review of Funding Levels and Risks