DISCUSSION ITEM

Agenda Item # 9

AGENDA REPORT SUMMARY

Meeting Date: December 14, 2021

Subject: CALPERS Unfunded Accrued Liability Paydown

Prepared by: John M Furtado, Finance Director
Approved by: Gabriel Engeland, City Manager

Attachment(s):
1. CALPERS Risk Mitigation Policy
2. Resolution Authorizing the pay down of CAPLERS UAL by $ 5 Million

Initiated by:

Staff

Previous Council Consideration:
-

Fiscal Impact: Funding of a partial pay down of the City's CalPERS liability will come from the City's General Fund CALPERS reserve ($5M) and will provide long term anticipated savings of 6.38 Million.

Environmental Review: Not Applicable

Policy Question(s) for Council Consideration:

Does the Council wish to use the CAPERS Reserve to paydown the Unfunded Accrued Liability (UAL)?

Summary:

The City provides a defined benefit pension plan to its employees through the California Public Employee Retirement System (CalPERS). This benefit serves as an important competitive tool for public agencies to attract and retain a skilled workforce. However, CalPERS funded status has declined over the past decade and was only 68.5 percent funded (for the pool) as of June 21 forecasts. As a result, contributions/payments from public agencies, including the City of Los Altos to CalPERS are growing at alarming rates anticipated at 17 and 14% increase for the next

Reviewed By:

City Manager	City Attorney	Finance Director
GE	JH	JF

two years, flattening to an average of 4- 5% for the years FY 24-32 before tapering down as the PEPRA workforce effects kick in.

Staff presented several options on the subject to the financial commission on their September 20th, 2021, meeting and the Finance Commission has recommended that the City Council consider using at least the $5 Million to paydown UAL, the Finance Commission further advised that the City Council consider identifying more funds, if available after the close of books to apply towards the unfunded liability.

Staff Recommendation:
Staff recommends that currently, the City Council adopt the resolution (**Attachment 2**) to transfer the PERS reserve amount of $5 Million to paydown the City's unfunded liability.

Background

The City of Los Altos pensions are pre-funded, as opposed to pay-as-you-go retirement systems like Social Security. In a pre-funded system, the employer and employee make contributions into a pension trust each year, over the course of an employee's working life. That money is invested and earnings on these funds are re-invested. By the time the employee reaches retirement, the accumulated assets in the trust are available to pay benefits. The objective is to accumulate sufficient assets to pay the benefits over the remainder of the employee's life. To meet this objective, a pension plan should receive contributions in accordance with an actuarially based funding policy. The actuarially determined pension funding plan determines exactly how much the employer and employee should contribute each year to ensure that the benefits being earned will be securely funded in a systematic fashion.

Plan assets come from three distinct sources including employee contributions, employer contributions and investment income.

Since actuarial assumptions are for the long term, demographic and economic assumptions can vary from actual experience. There are many moving parts such as mortality experience, retirement rates, disability incidences, salary growth, investment returns and more. An actuarial plan valuation is therefore prepared each year to true-up contributions levels to better match actual experience.

A key variable for the actuarial calculations is the discount rate, which is the rate of return that CalPERS assumes it will realize on its investments. CalPERS has been slowly lowering its discount rate in recognition that its assumptions about rate of return have been overly optimistic. For Fiscal Year 2019-20, the discount rate was 7.25%. For FY 2020-21, it is 7%.

In July of this year, CALPERS declared investment returns of 21.3%, for the 12-month period ended June 30, 2021. This Triggered the Funding Risk Mitigation Policy. **(Attachment 1)**

Under the Funding Risk Mitigation Policy, approved by the CalPERS Board of Administration in 2015, the double-digit return will trigger a reduction in the discount rate used to calculate employer and Public Employees' Pension Reform Act (PEPRA) member contributions. The discount rate, or assumed rate of return, will drop to 6.8%, from its current level of 7%.

The Funding Risk Mitigation Policy lowers the discount rate in years of good investment returns. This is the first time it has been triggered

Furthermore, there is a general consensus that the current rate of return may not be sustainable in the long run, and that CALPERS may consider reducing the discount rate from the current 6.8% to at least 6% in a phased manner, this action would further increase the UAL for most cities. The CALPERS Asset Liability, board usually looks at these every 4 years or so. The board is currently reviewing the proposed investment portfolios and expected returns to decide that the appropriate discount rate will be.

The City of Los Altos has six retirement plans with CAPERS, the Major 2 being the Safely plan, to cover sworn officers and the other being the Miscellaneous plan covering all other employees. All the Cities planned are pooled. The table below shows the projected status of the UAL for the year ended 2021.

Table 1

UAL as of June 30, 2021

Type	Pension Liab	Funded Amt	UAL	% Funded
Safety	64,640,177	45,528,664	19,111,513	70.4%
Miscellaneous	79,632,337	56,374,734	23,257,604	70.8%
Totals	**144,272,515**	**101,903,398**	**42,369,117**	**70.6%**

*Based on CALPERS measurement date of June 30, 2020, that is based on June 30, 2019, valuations (a two-year rollback)

Subject: CALPERS Unfunded Accrued Liability Paydown

Staff worked on computing several scenarios on the distribution of the prepayment between the Safety and Miscellaneous plans. While there are an infinite number of combinations and permutations possible, key considerations were the following.

1. What scenario would produce the greatest long-term Dollar ($) impact in savings?

Staff determined that paying off the longest amortization schedules would yield the best total financial impact, as you can see in table 2, paying off $5 Million between the 2 plans yields a total savings of 6.38 Million.

2. What is the current funded status of the different plans?

Staff looked at the current total UAL for the two plans as shown in the table 1 and determined that it would make most sense to equate the percentage (%) of Funded status of the two plans. Staff recommends paying down $2.73 Million towards the Miscellaneous plan and $2.27 Million towards the Safety Plan, this will improve the funding status of each plan to 73.1% at the time of making this payment.

3. Can we earn more than 6.8% over time?

Governments are severely restricted in how they can invest surplus funds by needing to conform to all State statutes (California Government Code (Gov. Code) §53600, et seq.) and City ordinances governing the investment of public funds.

Our current LIAF returns are 0.2% and hit a 10-year peak of 2.45% in May of 2019. The PFM managed portfolio is currently yielding less than 0.8% on cost, again way below the CAPLERS discount rate of 6.8%

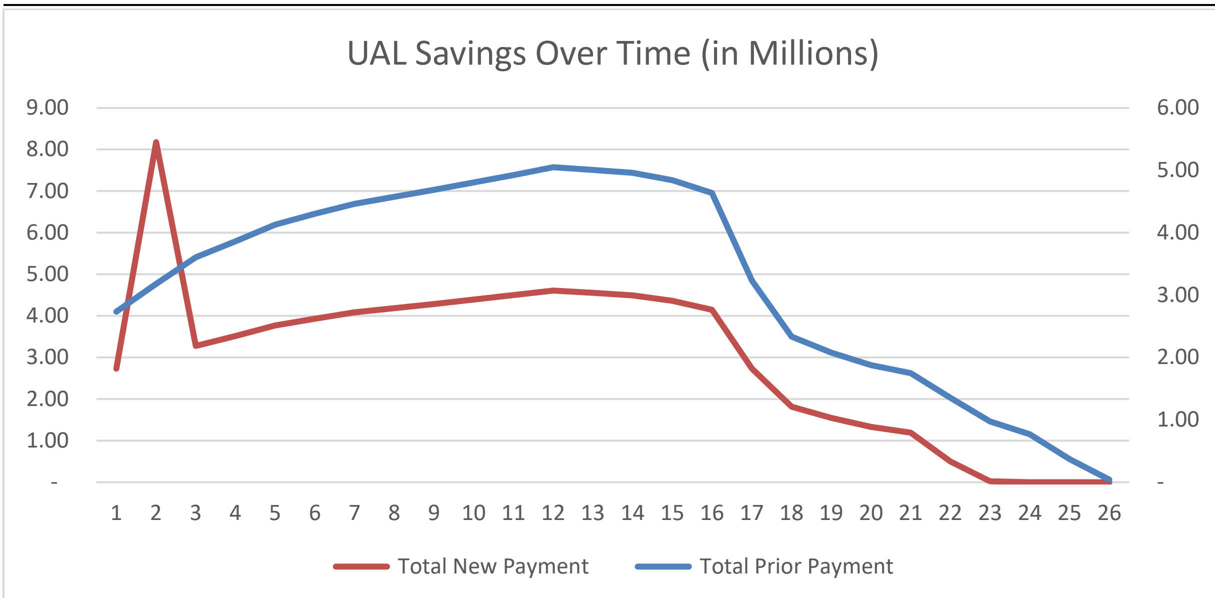
A third option could be to invest the money is a Section 115 Trust fund, staff reviewed the performance over time for this option and determined that the average return was still below 5.5% for the trust.

Subject: CALPERS Unfunded Accrued Liability Paydown

Table 2

Table of UAL Payments required over Time. (All Values in Millions)

	Miscellaneous Plan			Safety Plan			Totals		
Year	Prior Payment	New Payment	$ Value	Prior Payment.	New Payment.	$ Value.	Total Prior Payment	Total New Payment	$ Value Total
2020-21	1.5	1.5	-	1.2	1.2	-	2.73	2.73	-
2021-22	1.8	4.5	2.73	1.4	3.7	2.27	3.18	8.18	5.00
2022-23	2.0	1.8	(0.18)	1.6	1.5	(0.15)	3.61	3.28	(0.33)
2023-24	2.1	2.0	(0.19)	1.7	1.6	(0.16)	3.86	3.52	(0.34)
2024-25	2.3	2.1	(0.20)	1.8	1.7	(0.16)	4.13	3.77	(0.36)
2025-26	2.4	2.2	(0.20)	1.9	1.8	(0.17)	4.30	3.93	(0.37)
2026-27	2.5	2.3	(0.21)	2.0	1.8	(0.17)	4.47	4.08	(0.38)
2027-28	2.5	2.3	(0.21)	2.0	1.9	(0.18)	4.58	4.18	(0.39)
2028-29	2.6	2.4	(0.22)	2.1	1.9	(0.18)	4.69	4.29	(0.40)
2029-30	2.7	2.4	(0.23)	2.1	2.0	(0.19)	4.81	4.39	(0.42)
2030-31	2.7	2.5	(0.23)	2.2	2.0	(0.19)	4.93	4.50	(0.43)
2031-32	2.8	2.6	(0.24)	2.3	2.1	(0.20)	5.05	4.61	(0.44)
2032-33	2.8	2.5	(0.25)	2.2	2.0	(0.20)	5.01	4.56	(0.45)
2033-34	2.8	2.5	(0.25)	2.2	2.0	(0.21)	4.96	4.50	(0.46)
2034-35	2.7	2.4	(0.26)	2.2	1.9	(0.22)	4.84	4.37	(0.48)
2035-36	2.6	2.3	(0.27)	2.1	1.8	(0.22)	4.64	4.15	(0.49)
2036-37	1.3	1.1	(0.27)	1.9	1.7	(0.23)	3.23	2.73	(0.50)
2037-38	1.2	0.9	(0.28)	1.1	0.9	(0.23)	2.33	1.82	(0.52)
2038-39	1.1	0.8	(0.29)	1.0	0.8	(0.24)	2.08	1.55	(0.53)
2039-40	1.0	0.7	(0.30)	0.9	0.7	(0.25)	1.88	1.33	(0.54)
2040-41	0.9	0.6	(0.31)	0.9	0.6	(0.25)	1.75	1.19	(0.56)
2041-42	0.7	0.1	(0.59)	0.7	0.4	(0.26)	1.35	0.50	(0.85)
2042-43	0.5	-	(0.48)	0.5	0.0	(0.48)	0.97	0.02	(0.96)
2043-44	0.4	-	(0.38)	0.4	-	(0.39)	0.77	-	(0.77)
2044-45	0.2	-	(0.16)	0.2	-	(0.21)	0.37	-	(0.37)
2045-46				0.0	-	(0.04)	0.04	-	(0.04)
Totals	**45.87**	**42.41**	**(3.46)**	**38.68**	**35.76**	**(2.92)**	**84.55**	**78.17**	**(6.38)**



Recommendation

Staff recommend the City Council adopts the resolution to transfer $5 million as unanimously approved by the Finance Commission.

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF POLICY FOR
FUNDING RISK MITIGATION

Purpose

The California Public Employees' Retirement System ("CalPERS" or the "System") Board of Administration ("Board") has established a key strategic goal of improving long-term pension benefit sustainability. This goal is to be pursued through funding the System with an integrated view of pension assets and liabilities and actively assessing and managing funding risk through an Asset Liability Management ("ALM") framework. This document sets forth the policy ("Policy") for funding risk mitigation, which is a significant component of the overall ALM framework.

Contents

Background

The Funding Risk Mitigation (“FRM”) Policy seeks to reduce CalPERS funding risk over time. It establishes a mechanism whereby CalPERS investment performance that significantly outperforms the discount rate triggers adjustments to the discount rate, expected investment return, and strategic asset allocation targets.

Staff Implementation of the Policy is overseen by the Asset Liability Management Advisory Committee (“ALMAC”), chaired by the Chief Financial Officer (“CFO”) and made up of representatives from the financial office (“FINO”), investment office (“INVO”), actuarial office (“ACTO”), legal office (“LEGO”) and communications and stakeholder relations (“CSR”).

Strategic Objective

The strategic objective of the Policy is to reduce the volatility of investment returns, thereby increasing the long-term sustainability of CalPERS pension benefits for members.

Policy

If a Funding Risk Mitigation Event occurs, the discount rate and expected investment return shall be adjusted as set forth in Table 1 below, and the strategic asset allocation targets shall be adjusted consistent with such new discount rate and expected investment return. The current CalPERS strategic asset allocation targets can be found in the CalPERS Total Fund Investment Policy, and are defined or approved during the periodic Asset Liability Management process undertaken by CalPERS, subject to adjustments per this Policy.

Table 1: Funding Risk Mitigation Event Thresholds and Impacts

Excess Investment Return	**Reduction in Discount Rate**	**Reduction in Expected Investment Return**
If the actual investment returns exceed the discount rate by:	*Then the discount rate will be reduced by:*	*And the expected investment return will be reduced by:*
2.00%	0.05%	0.05%
7.00%	0.10%	0.10%
10.00%	0.15%	0.15%
13.00%	0.20%	0.20%
17.00%	0.25%	0.25%

Policy (continued)

Discount rate reduction shall be governed by the following parameters:

a. Reduced by increments of five (5) basis points (0.05%)
b. Maximum reduction per year of 25 basis points (0.25%)
c. The discount rate/expected investment return shall not be reduced to the point where the estimated investment return volatility drops below eight percent (8%) according to the Capital Market Assumptions most recently adopted by the Investment Committee.

Upon the occurrence of a Funding Risk Mitigation Event:

1. Staff shall report the annual net investment return for the given fiscal year ending June 30th to the CalPERS Board of Administration.
2. Staff shall implement new strategic asset allocation targets based on the reduction in investment return indicated in Table 1 in accordance with the current schedule of asset allocation ranges and targets adopted by the Investment Committee.
3. The new strategic asset allocation targets shall take effect on October 1 of the fiscal year immediately following the Event Year.
4. The total fund policy benchmark shall be adjusted consistent with the new strategic asset allocation targets and Staff shall report the new strategic asset allocation targets, total fund policy benchmark and expected investment return to the Investment Committee.
5. The discount rate shall be adjusted and reported to the Finance & Administration Committee.
6. Member calculations, including optional factors and service credit purchase, shall reflect the reduced discount rate effective immediately upon the occurrence of a Funding Risk Mitigation Event.
7. The effect of any reduction in discount rate for a given Event Year shall be included in the actuarial valuations calculated as of June 30 for such year.

Policy Scope

This Policy applies to Public Employees' Retirement Fund ("PERF") as well as the Affiliate Funds of the System, as applicable.

Funding Risk Mitigation Policy

Primary Responsibility

The ALMAC, under the direction of the CFO as chairperson, is responsible for this Policy. The Finance and Administration Committee ("FAC" or "Committee") is the Board committee responsible for overseeing staff's implementation of the Policy. The Committee intends for the Policy to be a dynamic document which will be reviewed and modified periodically to reflect the changing nature of CalPERS' assets and investment programs, benefit programs and economic conditions.

Key Terms / Definitions

For the purposes of this document, the following terms and definitions apply.

Key Term	Definition
Funding Risk Mitigation Event	The achievement of a time-weighted annual investment return net of investment expenses for a given fiscal year, as first publicly reported following the end of such fiscal year, that exceeds the CalPERS discount rate by 2.00% or more.
Event Year	The fiscal year in which the funding risk mitigation event occurred.
Threshold	The time-weighted annual investment return, net of investment expenses, in excess of the discount rate required for a funding risk mitigation event to occur.

Roles and Responsibilities

Staff's responsibilities with respect to the Policy shall include:

1. Reporting Funding Risk Mitigation Events to the FAC and implementing this Policy as these events occur.

2. Reviewing all funding risk mitigation actions taken with the FAC.

3. Reporting funding risk mitigation progress to the FAC in the Annual Funding Levels and Risks Report.

4. Reviewing the Policy with the Board as part of the cyclical Asset Liability Management (ALM) process.

Roles and Responsibilities (continued)

The FAC's responsibilities with respect the Policy shall include:

1. Overseeing senior management as they take steps to (1) manage, measure, monitor and control funding status and risks and (2) implement this policy.

2. Reviewing Staff recommendations for changes to the Policy and taking these recommendations for approval to the Board of Administration.

Authoritative Sources

CalPERS will administer this policy in compliance with the following legal, regulatory and policy requirements:

Source	**Description**
Cal. Gov't. Code §20120	The CalPERS Board of Administration is vested with the management and control of the Public Employees' Retirement System (the "System").
California Constitution, ART. XVI, § 17	The Board has plenary authority and fiduciary responsibility for the investment of monies and administration of the System. The Constitution also vests the Board with the sole and exclusive power to provide for the actuarial services in order to assure the competency of the System.

Related Documents

For additional information, please refer to:

Document	Relevance
Asset Liability Management Policy	The Board has established a key strategic goal of improving long-term pension benefit sustainability. This goal is to be pursued through funding the System with an integrated view of pension assets and liabilities and actively assessing and managing funding risk through an Asset Liability Management ("ALM") framework. This policy establishes the overall ALM framework and serves as a guide for the Funding Risk Mitigation Policy.
Total Fund Investment Policy	Provides a framework for the management of CalPERS assets and outlines the objectives, benchmarks, restrictions and responsibilities of the investment program. Sets out the process for establishing asset class allocation policy targets and ranges and managing those asset class allocations within their policy ranges.

Revision History

The following revisions have been made to this policy:

Version	Modification Date	Summary of Changes
2.0	February 14, 2017	Lowers the first threshold for the percentage by which actual investment return exceeds the discount rate in any fiscal year in order to trigger a discount rate reduction from 4.0% to 2.0%. Note: The Board has suspended implementation of this Policy until FY 2020-21.
1.0.	Nov. 15, 2015.	This was the initial FRM Policy.

ATTACHMENT 1

RESOLUTION NO. 2021-62

A RESOLUTION OF THE CITY COUNCIL OF THE CITY OF LOS ALTOS ADOPTING THE TRANSFER OF $5 MILLION TO CALPERS TO PAY DOWN THE CITY'S UNFUNDED ACCRUED LIABILITY

WHEREAS, it has been determined that the adoption of a Transfer of the CAPLERS Reserve Fund of Five Million Dollars to pay down the City's Unfunded Accrued Liability is an effective and prudent management tool; and

WHEREAS, on September 20, 2021, the Financial Commission recommended the City use the $5 million PERS Reserve as well as any additional funds that may be available to pay down a portion of the City's Unfunded Accrued Liability.

NOW THEREFORE, BE IT RESOLVED, that the City Council of the City of Los Altos hereby finds and determines that:

1. The City of Los Altos Unfunded Accrued Liability has been presented and reviewed by City Council, appropriations to the extent of the PERS Reserve of $ 5 million is established; and

2. The City Manager is authorized to Transfer the Sum of $2,270,000 (Two million two hundred and seventy thousand) to the City's Safety CALPERS retirement plan AND to transfer the sum of $2,730,000 (Two million seven hundred and thirty thousand) to the City's Safety CALPERS retirement plan; and

3. City Staff shall determine the appropriate timing of the payment, based on the cash flow, subject to completing the transfer in the Calendar year of 2021.

I HEREBY CERTIFY that the foregoing is a true and correct copy of a Resolution passed and adopted by the City Council of the City of Los Altos at a meeting thereof on the 14th day of December, 2021 by the following vote:

AYES:
NOES:
ABSENT:
ABSTAIN:

____
MAYOR

Attest:

____
Andrea Chelemengos, MMC, CITY CLERK