



STAFF REPORT

January 26, 2022
File Number 0460-20

SUBJECT

CALPERS PENSION FUNDING WORKSHOP

DEPARTMENT

Finance

RECOMMENDATION

Request the City Council Receive and file information on the City's California Public Employees Retirement System pension obligations.

Staff Recommendation: Receive and File (Finance Department: Christina Holmes)

FISCAL ANALYSIS

Ongoing information for budget planning purposes.

BACKGROUND

The City of Escondido ("City") provides retirement benefits to its employees who provide the City services residents rely on, by contracting with the California Public Employees Retirement System ("CalPERS"). The City has taken decisive action on pension reform and saving significant taxpayer dollars by addressing this cost head on. CalPERS offers a defined benefit plan where retirement benefits are based on a formula, rather than contributions to and earnings from a savings plan such as those commonly used in the private sector such as 401ks. Retirement benefit formulas are calculated based on an employee's years of service credit, age at retirement, and final compensation, which is determined by an employee's average salary, excluding overtime, for a defined period of employment. Retirement formulas for employee groups vary based on classification (Miscellaneous or Safety), and within these groups, by date of entering CalPERS membership ("Classic" or "PEPRA" if entered into CalPERS after January 1, 2013).

The City continues to be a responsible and accountable fiscal steward of taxpayer dollars through pension reform and maintaining a stringent budget. In 2013 California pension reform became law under the Public Employees' Pension Reform Act ("PEPRA"). PEPRA, effective for all new employees hired after January 1, 2013, made broad prospective changes to pensions in California with the goal to create a more sustainable pension system by reducing employer's pension liabilities and increasing employee contributions towards their pension benefits. However, savings from the reform will take many years to be realized.



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CalPERS Projected Contribution and Funding Levels

Retirement benefits are funded by contributions from both employees and the City (“normal” annual service costs) as well as investment earnings. Annual contribution amounts are determined based on a percentage of payroll and in accordance with an actuarially based funding policy. The actuarially-determined pension funding plan determines exactly how much should be contributed each year to ensure that the benefits being earned will be securely funded in a systematic fashion. Since actuarial assumptions are for the long term, demographic and economic assumptions can vary from actual experience. There are many factors considered 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 contribution levels to better match actual experience.

CalPERS invests contribution payments with the goal of earning sufficient returns over the long-term to pay defined benefits as promised and cover CalPERS expenses. Historically, more than 60% of all funds paid to CalPERS retirees comes from investment earnings. The estimated long-term average return expected to be earned on investments is referred to as the “discount rate”. When lower investment earnings occur, future contributions must increase to make up the expected difference and an unfunded accrued liability (“UAL”) is created. The UAL represents the shortfall or gap between what is needed to pay retiree benefits versus how much in current assets the City actually has in its accounts with CalPERS. The UAL is calculated annually and changes depending on the demographic trends of the plan participants.

For many years, due to positive investment returns, CalPERS cities were “superfunded,” meaning total plan assets exceeded the total CalPERS projected liability. However, during the Great Recession and resulting downturn in the economy, investment returns were impacted negatively nationwide, including CalPERS investments, decreasing the City’s total plan assets and creating an unfunded liability. In addition to the investment losses, adjustments have been made to demographic assumptions such as higher retirement rates, and also the expectation that retired employees are living longer, which have also contributed to the increasing liability.

CalPERS and the City of Escondido have taken a number of actions to address unfunded liabilities across its member plans with the objective of reaching 100 percent funded status. Since December 2016, CalPERS has been lowering its discount rate in recognition that its assumptions about the rate of return on investments have been overly optimistic. The discount rate was lowered from 7.5% to 7.0% over a 3-year period beginning with the June 30, 2016 valuation. Without any offsetting action, reducing the discount rate increases costs to member agencies in the short-term. In the long-term, the reduced rate is expected to lower the cost to member agencies as CalPERS is more likely to achieve the investment earnings target.



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When CalPERS last reduced its discount rate, causing employer liabilities to significantly increase, CalPERS also implemented a “ramp up” strategy to smooth out the increases in UAL contributions. As opposed to a fixed-level payment schedule, CalPERS began using a 25-year amortization schedule where payments are ramped up in the beginning years and ramped down in the ending years.

The table below provides more detailed information about the total employer contributions to CalPERS for the Miscellaneous and Safety Plans over the last five years. As the table reflects, the normal cost for the Miscellaneous and Safety Plans have increased 7% and 3%, respectively, over the last five years. The UAL for the Miscellaneous and Safety Plans have increased 63% and 85%, respectively, over the same time period. For reference, General Fund revenues increased 10% between FY2019/20 to FY2020/21 and Projected Revenue Growth is about 3% each year. While a portion of pension contributions for the Miscellaneous group is provided by funds other than the General Fund, it is anticipated that the General Fund will have responsibility for approximately 78% of the annual unfunded liability.

Annual Payments	2017-18	2018-19	2019-20	2020-21	2021-22	5-Year Increase	
UAL Miscellaneous Plan	\$8,267,000	\$9,607,958	\$11,026,653	\$12,089,955	\$13,503,578	\$5,236,578	63%
UAL Safety Plan	5,387,634	6,574,242	7,832,654	8,845,044	9,952,564	4,564,930	85%
UAL Total	13,654,634	16,182,200	18,859,307	20,934,999	23,456,142	9,801,508	72%
Normal Cost Miscellaneous Plan	3,802,260	3,750,135	4,138,487	4,439,106	4,082,911	280,651	7%
Normal Cost Safety Plan	5,100,798	4,893,714	5,032,595	5,649,745	5,273,860	173,062	3%
Normal Cost Total	8,903,058	8,643,849	9,171,082	10,088,851	9,356,771	453,713	5%
Total	\$22,557,692	\$24,826,049	\$28,030,389	\$31,023,850	\$32,812,913	\$10,255,221	45%

Required annual payments to CalPERS towards the UAL have increased significantly and the payments are projected to grow annually. While PEPRA and CalPERS actions subsequent to PEPRA will reduce the City's pension liabilities, the annual budgetary effects of this reform will not materially be realized by the City for many years.

Actions Taken to Address Increasing Costs

The City has taken several steps to address the CalPERS pension costs. These have included:

- 1) Lower Benefit Tiers for Employees. Taking advantage of state legislation, two new lower benefit tiers have been established with CalPERS: Tier 2 Employees hired in 2011-12 (depending on employee group) are required to pay the full employee contribution upon hiring. Tier 3 was created in 2013 as a result of the California Public Employees' Pension Reform Act (PEPRA) and



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establishes a reduced tier of benefits for new CalPERS employees. The employee share for PEPRAs employees is higher than that for Tier 1 and Tier 2 employees.

- 2) Employee Cost Sharing. In 2018, to help address the long-term budget impacts as a result of CalPERS pension liabilities, the Firefighters Association, Police Officers Association, and Maintenance & Operations bargaining units agreed to share in the costs of the employer's CalPERS contribution. Prior to the agreements, Classic CalPERS Safety members were contributing 9% and Classic CalPERS Miscellaneous members were contributing 8% of their salary towards the employee's retirement benefit. The amount increased by 1% each year until the additional contribution reached 3% for each group. Classic CalPERS Safety members are currently contributing 12% and Classic CalPERS Miscellaneous members are contributing 11% towards their CalPERS retirement benefit.
- 3) Prepayments to CalPERS. Since FY2017/18 the City has prepaid the annual Unfunded Accrued Liability payment at the beginning of each fiscal year to save 3.5% (approximately \$800,000/year).
- 4) Creation of a Section 115 Trust. Historically, Internal Revenue Code Section 115 Irrevocable Trusts have been used to pre-fund other post-employment benefits. In 2015, Public Agency Retirement Services (PARS) received a favorable private letter ruling from the Internal Revenue Service that allows public agencies to pre-fund pension obligations in a Section 115 Irrevocable Trust. This ruling allows the City to safely and securely set aside funds, separate and apart from the state retirement system, in a tax-exempt irrevocable trust to reduce pension liabilities and stabilize pension costs.

The City Council conducted a Pension Workshop on September 27, 2017, and determined to establish a Section 115 Irrevocable Pension Trust. On February 14, 2018, the City Council authorized the establishment of the Trust with PARS. The City Council also approved a deposit of \$1,984,000 to initially fund the Trust. Since then, Council policy have resulted in additional contributions from: (1) Successor Agency Loan Repayment (final payment received in FY2021/22); (2) proceeds from the sale of City property belonging to the General Fund; (3) and any General Fund surplus realized at the end of each fiscal year. The Section 115 Pension Trust Fund currently has a balance of \$26.8 million (December 2021).

- 5) Annually – Staff implement operational efficiencies, where possible, to minimize costs and impact to service levels as CalPERS costs increase.

Recent CalPERS Board Action

In July 2021, CalPERS reported investment returns of 21.3%, for the 12-month period ended June 30, 2021. This triggered a Funding Risk Mitigation Policy approved by the CalPERS Board of Administration in 2015. Under the Funding Risk Mitigation Policy, the double-digit return will cause a reduction in the discount rate used to calculate employer and Public Employees' Pension Reform Act (PEPRA) member



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contributions. The discount rate, or assumed rate of return, will drop to 6.8%, from its current level of 7%. As explained above, this action is outside the City's control, and will result in a higher required CalPERS payment.

Next Steps

As we begin the FY2022/23 budget process and review and review the feedback on community needs and priorities gathered from the 2021 Community Satisfaction Survey, it is important to understand the budgetary impacts of the actions taken by the CalPERS Board and the effect that the UAL has on the General Fund now and into the future. Therefore, staff have contracted with Bartel Associates, LLC, to provide an analysis and update on the City's CalPERS program. Bartel Associates, LLC is an independent actuarial firm that provides actuarial valuation, consulting, and advisory services to large and small retirement systems in the state of California.