CITY OF RIVERSIDE

City of Arts & Innovation

Budget Engagement Commission

TO: HONORABLE COMMISSIONERS **DATE: AUGUST 31, 2017**

FROM: FINANCE DEPARTMENT **WARD: ALL**

SUBJECT: CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (CALPERS) PENSION COSTS UPDATE

ISSUE:

Receive an update about the California Public Employees' Retirement System (CalPERS) pension costs as of July 31, 2017.

RECOMMENDATIONS:

That the Budget Engagement Commission (BEC) receive an update on the impact of CalPERS pension rate increases on current and future City budgets.

BACKGROUND:

During the March 30, 2017 BEC meeting, City Staff presented information about preliminary five-year CalPERS pension cost projections during the presentation on Measure Z Spending related to Public Safety and Capital/Infrastructure.

During the April 12, 2017 Finance Committee meeting, City Staff presented information about the financial impact of the CalPERS changes to its discount rate.

During the June 8, 2017 BEC meeting, the BEC requested a comprehensive discussion of CalPERS with a focus on future liabilities and future growth. City Staff offered to present a CalPERS update after CalPERS distributed the City's yearly Actuarial Valuation Reports for miscellaneous (non-sworn) and public safety (sworn) employees.

DISCUSSION:

Recent CalPERS Changes

The City's relationship with CalPERS to provide a defined benefit retirement to its employees dates back to 1945 when it was approved by Riverside voters during a Special Election on June 5 of that year. A CalPERS overview and update for the City is provided on Attachment 1.

Since 1945, there have been many changes to the pension formula. Significant changes over the last 15 years are reflected on the table on the next page:

Pension Formula Changes			
Fiscal Year	**CalPERS Group**	**Formula From**	**Formula To**
*Pension Enhancement (CalPERS **cost increases**)*			
FY 2001/02	Safety (Police and Fire)	2%@50	3%@55
FY 2002/03	Misc. (All Non-Sworn)	2%@55	2.7%@55
FY 2004/05	Safety (Police)	3%@55	3%@50
FY 2005/06	Safety (Fire)	3%@55	3%@50
*Pension Reform (CalPERS **cost savings***)*			
FY 2010/11	Safety (Fire)	N/A	3%@55 - Est. of Tier 2
FY 2012/13	Misc. (All Non-Sworn)	N/A	2%@62 – PEPRA** - Est. of Tier 3
FY 2012/13	Safety (Police and Fire)	N/A	2.7%@57 - PEPRA - Est. of Tier 3

* Additional CalPERS cost savings were achieved without a formula change in FY 2011/12 (Safety-Police) and (Misc. - All Non-Sworn) by requiring new employees to pay the Employee Portion of CalPERS Costs. Future CalPERS savings will be achieved through newly negotiated union agreements, which require the pickup of CalPERS costs through the Partnership Compensation Model.

** On January 1, 2013 the California Public Employees' Pension Reform Act of 2013 (PEPRA) went into effect. The pension reform bill impacts new public employees and establishes a cap on the amount of compensation that can be used to calculate a retirement benefit.

Updated Citywide CalPERS Pension Cost Projections

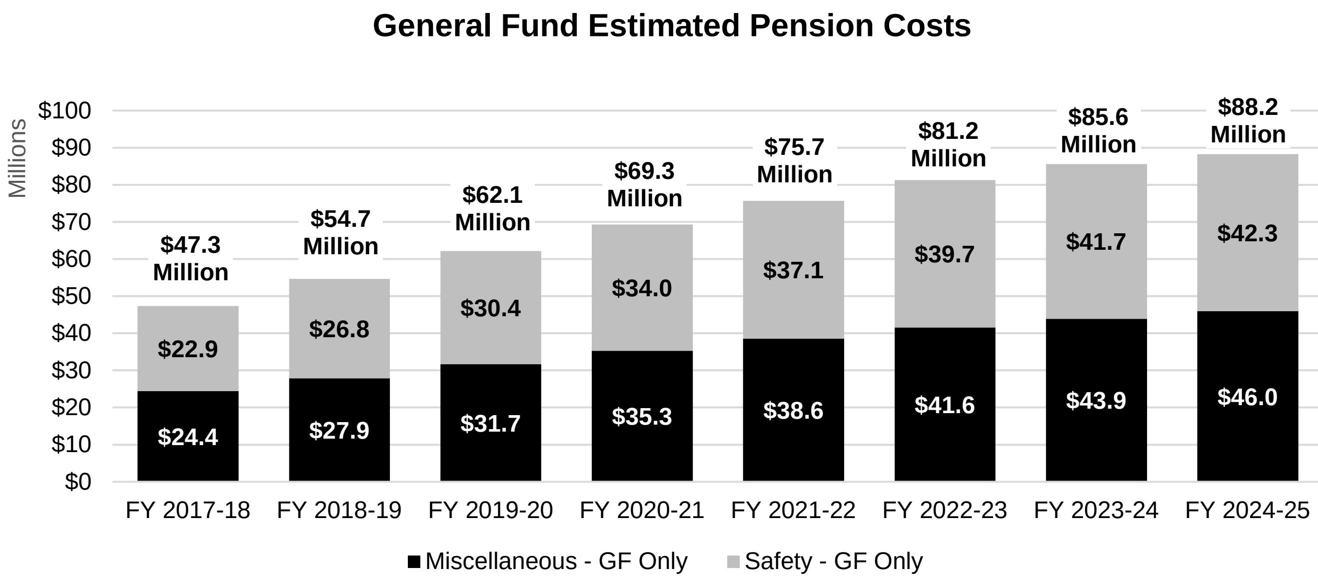
Overall, updated pension cost projections show expected costs are at the lower end of the range presented to the Finance Committee in April 2017. Overall, citywide pension costs are expected to increase by 86.5% over the next seven years. The table below shows citywide projected CalPERS pension cost through FY 2024-25:

Citywide Projected CalPERS Pension Costs

Fiscal Year	Updated Projected Pension Costs	Change from the Previous Year	
FY 2017-18	$69,725,489	-	-
FY 2018-19	$80,614,010	$10,888,521	15.6%
FY 2019-20	$91,591,262	$10,977,252	13.6%
FY 2020-21	$102,113,969	$10,522,707	11.5%
FY 2021-22	$111,586,360	$9,472,391	9.3%
FY 2022-23	$119,737,170	$8,150,810	7.3%
FY 2023-24	$126,119,895	$6,382,725	5.3%
FY 2024-25	$130,026,232	$3,906,337	3.1%
Cumulative Total (FY 2017-18 vs FY 2024-25)		**$60,300,743**	**86.5%**

<u>Updated General Fund CalPERS Pension Cost Projections</u>

General Fund pension costs are expected to increase more than $40.0 million or 86% over the next seven fiscal years. For FY 2018-19, the cost will be $7.4 million more than the previous fiscal year.



The City has taken several steps over the last 13 years to reduce pension related costs:

- **Every Year** – Implement operational efficiencies to allow a smaller workforce with minimal impact to service levels provided to the community.
- **2004 & 2005** – Issued Pension Obligation Bonds (POBs) for Unfunded Actuarial Liability (UAL) totaling $149.5 million. $30 million was issued as a Series B Interest Only bond.
- **2007** – Refinanced $30 million interest-only POB with an interest-only Bond Anticipation Note (BAN).
- **2015** – Required all new employees to pay the employee portion of the CalPERS pension costs.
- **2013** – Complied with the Public Employee Reform Pension Act and established separate employee benefit tiers for new employees subject to the legislation. The new tiers utilized new formulas that resulted in lower pension costs.
- **2017** – Refinanced $30 million BAN using Measure Z Funds. Allowed a fixed interest rate for the pension related debt and an accelerated payoff of the principal balance.

<u>CalPERS Changes Methodology for Billing Local Agencies in FY 2017/18</u>

CalPERS has made changes to how local agencies are charged for retirement costs. The calculation was a blended rate of normal cost combined with the rate of Unfunded Actuarial Liability (UAL) cost. It is now a percentage rate of payroll for the normal cost combined with a specified dollar amount for the UAL. Normal costs are the annual cost of service accrual for the upcoming fiscal year for active employees. Normal cost should be viewed as the long-term contribution rate for existing employees. UAL is a plan's accrued liability that is less than the value of the plan's assets. CalPERS allows the City to amortize the liability over a maximum of 30-years. The change in billing methodology did not have any impact on the City's FY 2017/18 budgetary estimates adopted by the City Council.

This change addressed funding issues that can occur from declining payroll or reduction in the number of active members in the plan. Funding the unfunded liability as a percentage of payroll led to the underfunding of the plans. Although employers will be invoiced at the beginning of the fiscal year for their unfunded liability payment, the plan's normal cost contribution will continue to be collected as a percentage of payroll.

As of the July 2017 CalPERS Actuarial reports, the City total UAL is approximately $603.2 million The City can elect to pay for the unfunded liability over a 20 or 15-year period. While paying over a shorter period would allow the City to save millions in "interest" payments over the long-term, the annual contribution amount would increase significantly and be unaffordable.

CalPERS Reports Positive Investment Returns for Fiscal Year 2016-2017

In July 2017, CalPERS reported a net return on investments of 11.2% for FY 2016-17. It was the best investment return in three years (FY 2014-15 was 2.4% and FY 2015-16 was 0.61%). Although this is movement in the right direction, CalPERS' long-term investment performance must be considered when evaluating the fund's performance. The following shows the short and long-term view of Return on Investments, as updated with the FY 2016-17 data:

Short and Long Term View of Return on Investments

11.2%	**8.8%**	**4.4%**	**6.6%**
FY 2016-17 Net Return of Investments	5-Year Net Return of Investments	10-Year Net Return of Investments	20-Year Net Return of Investments

Discount Rate Change

The discount rate is the estimated long-term average return expected to be earned on investments. The more gains made from a CalPERS plan investment, the less the City will need to contribute. CalPERS has reduced the discount rate to be more consistent with long-term market expectations. As a result, the City will need to contribute more each year.

History of CalPERS Discount Rate Changes

8.25%	**7.75%**	**7.50%**	**7.00%**
	Effective FY 2003-04	Effective FY 2011-12	Effective FY 2020-21

Additional discount rate changes will take effect in FY 2018-19 (7.35%) and FY 2019-20 (7.25%). The changes to the discount rates have resulted in additional costs to the General Fund that are $15.2 million over the last three years of the current five-year plan (FY 2018-19, FY 2019-20 and FY 2020-21).

The completion of the Asset Liability Management Review may have additional impacts to the discount rate. Every four years, CalPERS completes an Asset Liability Management Review. This process includes a review of the current asset allocations and the role of each asset class within the portfolio. Risk tolerances for each asset class are reviewed and capital market assumptions that will reflect financial market expectations are developed. **The next Asset Liability Management Review is currently in progress and is expected to be complete in February 2018.**

An Actuarial Assumption Review is also completed every four years. This review updates all actuarial assumptions (economic and demographic) as appropriate. Economic assumptions include the discount rate as well as wage and price inflation projection. The last review concluded in 2016 which resulted in the current discount rate reductions. The next Actuarial Assumption Review is expected to be completed in 2020.

Outstanding Pension Obligation Bonds (POBs)

The City has utilized Pension Obligation Bonds (POBs) to pay down its UAL and lower the interest cost associated with the outstanding pension liability. The table below shows the City's uses of POBs over the last 14 years.

Pension Obligation Bonds				
Fiscal Year	**CalPERS Group**	**Amount Issued**	**Notes**	**Expiration Date**
FY 2003/04	Safety (Police and Fire)	$89.5 M		FY 2022-23
FY 2004/05	Miscellaneous (All Non-Sworn)	$60 M	$30 M Series A (fixed rate) and $30 M Series B (Interest only)	FY 2019-20
FY 2007/08	Miscellaneous (All Non-Sworn)	$30 M	Refinanced Series B to **interest-only** Bond Anticipation Note (BAN)	Refunded
FY 2017/18	Miscellaneous (All Non-Sworn)	$32 M	Refinanced BAN to Series A POB	FY 2026-27

FISCAL IMPACT:

There is no immediate fiscal impact associated with this report. However, as part of the Fiscal Year 2018-2020 Two-Year budgetary process, increases in CalPERS costs will be taken into consideration to produce a balanced budget. While the significant increases in CalPERS are three to five years away, it is very important the City begin to plan and mitigate costs now, to the extent possible.

Prepared by: Karen Johnson, Principal Management Analyst
Approved as to availability of funds: Adam Raymond, Acting Chief Financial Officer / City Treasurer
Approved by: Marianna Marysheva, Assistant City Manager

Attachment:
1. CalPERS Overview and Update Handout
2. Presentation