City of Arts & Innovation

Finance Committee Memorandum

TO:	**FINANCE COMMITTEE MEMBERS**	**DATE:**	**APRIL 12, 2017**
FROM:	**FINANCE DEPARTMENT**	**WARDS:**	**ALL**

SUBJECT: FINANCIAL IMPACT OF THE CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM DISCOUNT RATE CHANGE

ISSUE:

The issue for Finance Committee consideration is a review of the impact of the December 2016 the California Public Employees' Retirement System (CalPERS) discount rate (interest rate) change.

RECOMMENDATION:

That the Finance Committee receive, provide input on and forward to the City Council a report on the impact of the CalPERS discount rate (interest rate) change.

BACKGROUND:

At its February 8, 2017 Finance Committee meeting, Chair Soubirous and Vice Chair Burnard requested a report on CalPERS discount rate (interest rate) change and options for long-term planning for a future Finance Committee meeting.

DISCUSSION:

Recent Pension 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 the voters of Riverside by Special Election on June 5, 1945. Recent changes to the City's CalPERS plans (miscellaneous and safety) and related pension changes, are summarized in the following charts.

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.

Pension Obligation Bonds			
Fiscal Year	**CalPERS Group**	**Amount Issued**	**Notes**
FY 2003/04	Safety (Police and Fire)	$89.5 M	
FY 2004/05	Misc. (All Non-Sworn)	$60 M	$30 M Series A (fixed rate) and $30 M Series B (Interest only)
FY 2007/08	Misc. (All Non-Sworn)	$30 M	Refinanced Series B to **interest-only** Bond Anticipation Note (BAN)
FY 2017/18	*Misc. (All Non-Sworn)*	*$30 M*	*Anticipated BAN Refinancing*

Discount Rate Change:

At their December 21, 2016 meeting, the CalPERS Board of Administration approved lowering the CalPERS discount rate assumption (long-term rate of return) from 7.50 percent to 7.00 percent over the course of three years. Based on the approved implementation, public agency employer contribution costs will increase, beginning in Fiscal Year 2018-19. In the past 15 years, CalPERS has changed the discount rate twice: 1) FY 2003/04: 8.25% to 7.75%; and 2) FY 2011/12: 7.75% to 7.5%. Both of these instances resulted in substantial increases to the City's CalPERS costs.

In mid-January 2017, CalPERS released guidance for local agencies on the estimated fiscal impacts of the discount rate changes. City staff estimate, based on CalPERS' guidance, that the City will experience cumulative CalPERS cost increases of approximately 45%-60% through FY 2020-21. **The cumulative additional cost to the General Fund would be between $16 million and $26 million over the last three years of the current five-year plan (i.e. FY 2018-19, FY 2019-20 and FY 2020-21)**.

In the future, CalPERS will provide more precise impacts to the City based on the funded status of the City's own pension funds that CalPERS administers. Better estimates are expected from CalPERS in July-September 2017, when updated actuarial reports are finalized. The City's estimates included in this report have been reviewed and validated by its independent actuary consultant, Nyhart. Detailed costs estimates are provided graphically in two formats: Attachment 1 - CalPERS/POB projections and timeline of events); and Attachment 2 - CalPERS projections, including General Fund.

Potential Future CalPERS Rate Changes:

Every four years, CalPERS goes through their Asset Liability Management (ALM) Review. This process includes a review of the current asset allocation and the role each asset class plays within the portfolio. It looks at risk tolerances for each asset class and most importantly, provides capital market assumptions that reflect the expectations of what the financial markets will deliver. The next review is due in February 2018. B**ased on the findings of this review, CalPERS could again reduce the discount rate to match the expected investment return.**

CalPERS also reviews all actuarial (economic and demographic) assumptions every four years. Economic assumptions include the discount rate, and wage and price inflation projections. Demographic assumptions include retirement, employment and mortality rate projections. The most recent cycle concluded in 2016, which lead to the current discount rate reduction from 7.5% to 7%. Previous reviews have also lead to discount rate reductions in 2004 (8.25% to 7.75%) and 2012 (7.75% to 7.5%). **The next Actuarial Assumption Review will conclude in 2020.**

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

CalPERS is changing the way they are charging local agencies for their retirement costs, from a blended rate to a percentage rate for the normal cost plus a specified dollar amount for the unfunded liability.

Normal Cost: The annual cost of service accrual for the upcoming fiscal year for active employees. The normal cost should be viewed as the long-term contribution rate for existing employees.

Unfunded Actuarial Liability (UAL): When a plan or pool's value of assets is less than its accrued liability, the difference is the plan or pool's unfunded liability. If a liability exists, the amortized liability must be paid by the City over a maximum of 30-years. The City can pay for the unfunded liability over a 20 or 15-year period if it elects to do so. By paying over a shorter period, the annual increases would be significant and generally unaffordable; however, the City would save millions in "interest" payments. As of the August 2016 CalPERS Actuarial reports, the City total UAL is approximately $464 million.

Per the City's most recent actuarial reports dated August 2016, "Beginning with Fiscal Year 2017-

18 CalPERS will collect employer contributions toward the plan's unfunded liability as dollar amounts instead of the prior method of [calculating] a contribution rate [which combined the Normal Cost and UAL into a single rate of payroll]. This change will address potential funding issues that could arise from a declining payroll or reduction in the number of active members in the plan. Funding the unfunded liability as a percentage of payroll could lead 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."

CalPERS Plan	Fiscal Year	Normal and UAL % of Payroll (Combined)	Employer Normal Cost Rate	Employer Payment of Unfunded Actuarial Liability (UAL)
Miscellaneous	FY 2016-17	22.98%	N/A	N/A
Miscellaneous	FY 2017-18	N/A	12.14%	$ 15,683,043.00
Safety	FY 2016-17	34.84%	N/A	N/A
Safety	FY 2017-18	N/A	19.87%	$ 12,351,650.00

The change in billing methodology does not have any impact on the City's FY 2017/18 budgetary estimates previously adopted by the City Council.

Options to Reduce City's CalPERS Costs:

Outside of changes to State law that would drastically alter CalPERS, the City's ability to reduce CalPERS costs are generally slated into long-term and short-term options. **Most of the options would require staff to re-negotiate existing contracts with the City's bargaining groups.**

Short-Term Savings:

- Employee pays a larger portion of the City's CalPERS by:
  - Pick up the employee portion paid by the City at a faster rate than provided under the recently negotiated Partnership Compensation Model (Tier 1 employees)
  - Pick up a portion of the City's employer portion

  Based on FY 2017/18 Adopted Budget figure, for each 1% of additional contribution by the employee, total savings would be approximately $2.1 million ($1.4 million for the General Fund)
- Non-PEPRA employees retiring/leaving the City and being replaced by PEPRA employees.
- A reduction in the City's workforce.

Long-term Savings:

- Reduce retirement benefit for employees coming to the City from other CalPERS or agencies with reciprocal plan (e.g. CalSTRS)
  - Example: Establishing a 2%@60 benefit for new, non-PEPRA miscellaneous (non-safety) employees to lower the normal cost charged to the City over time.
- Utilize pension obligation bond funding, upon payoff of debt, to pay down City's UAL.
  - Example: Utilize 2004 POB funding to pay down UAL, beginning in FY 2024/25 ($11.3 million).

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 need to be taken into consideration in order 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.

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Approved as to form:	Gary Geuss, City Attorney

Attachment:

1. Graph 1 – Estimated CalPERS/POB Costs and Funding Status
2. Graph 1 – Estimated CalPERS Cost (Citywide and General Fund)
3. CalPERS Discount Rate Change and Related Articles
4. Presentation