



Item No. 6 Town of Atherton

CITY COUNCIL STAFF REPORT – STUDY SESSION

**TO: HONORABLE MAYOR AND CITY COUNCIL
GEORGE RODERICKS, CITY MANAGER**

FROM: ROBERT BARRON III, FINANCE DIRECTOR

DATE: FEBRUARY 3, 2021

**SUBJECT: REVIEW AND DISCUSS A MEMORANDUM FROM THE TOWN'S
AUDIT AND FINANCE COMMITTEE REGARDING THE CALPERS
ACTUARIAL VALUATION REPORTS AND FUNDING TOWARD
PAYMENT OF THE TOWN'S PENSION OBLIGATIONS**

RECOMMENDATION

Review and discuss a Memorandum from the Town's Audit and Finance Committee regarding the CalPERS Actuarial Valuation Reports and Funding toward payment of the Town's Pension Obligations.

BACKGROUND | ANALYSIS

Each year the Audit and Finance Committee reviews the CalPERS actuary reports to develop an understanding of potential funding mechanisms for the Town pension liability. There have been numerous changes of the years implemented by CalPERS that impact pension liability. In 2019, the Committee reviewed the San Mateo County Grand Jury Report entitled "Soaring Pension Costs-Time for Hard Choices". The Grand Jury Report included findings and recommendations pertaining to cities in the County in handling their pension liabilities. The City Council reviewed and responded to the Grand Jury Report. The attached memorandum from the Committee is a presentation of recommendations for consideration by the Council.

POLICY FOCUS

Pension obligations are long-term liabilities for the Town. Fiscal stability is a core value of the Town and one of the objectives therein is to pursue the reduction of the Town's long-term liabilities.

ATTACHMENT

1. Finance Committee Report to City Council-Statement recommendation on Pension Liability Funding
2. Facts at a Glance-CALPERS
3. Charts for Market Value versus Accrued Liability



To: Honorable Mayor and City Council

From: Atherton Audit & Finance Committee

Date: January 24, 2021

SUBJECT: CALPERS ACTUARIAL VALUATION REPORTS

Staff Background

The Town is a member of the California Public Employee's Retirement System (CalPERS). CalPERS is the nation's largest public pension fund serving more than 2 million members in the retirement system and 1.5 million members and their families in their health program. CalPERS is governed by a 13-member Board of Administration. The CalPERS system takes its formation and structure from California law and provides retirement and health benefit systems to State, school, public agency, and special district employees. As of June 30, 2019, CalPERS' 2 million membership consists of 38% school members, 31% State members and 31% public agency members. The Town receives both retirement and health benefits for its employees through the CalPERS system.

Attached is a recent *Facts at a Glance for Fiscal Year 2018/19* from CalPERS indicating that the total Fund Market Value at the end of FY 2018/19 is \$372.6 billion. The Attachment shows CalPERS' Market Value, Net Investment Return, Asset Allocation, and Funded Status. Overall, the total Pension Funded Status is 71% at the end of FY 2018/19. As of June 2020, CalPERS' income dollar comes 58% from Investment Earnings, 29% from employer contributions, and 13% from member contributions.

Pension Programs

CalPERS pension systems operate as defined-benefit plans. Service credit is the time accrued while on the job for a CalPERS-covered employer. The minimum retirement age for service retirement for most members is 50 years of age with 5 years of service credit. The more service credit you have, the higher the retirement benefits. Retirement benefits are based on a formula (not what is contributed into the system). In broad summary, there are retirement formulas for Public Safety employees and different retirement formulas for non-public safety employees (called Local Miscellaneous). Public Safety employees have the opportunity to retire at a younger age with a higher retirement benefit.

In 2014, in an effort to manage growing retirement costs, CalPERS refined its retirement benefit plans closing its *Classic* plans to new members and requiring all new enrollees to be enrolled in the new *Public Employees' Pension Reform Act* Plans (PEPRA). PEPRA plans were created for both Public Safety and Local Miscellaneous employees. The Town has a total of 38 employees as of December 2020. Of that total, 19 are enrolled in the PEPRA plans and 19 remain Classic members.

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The Town has 4 basic plans, which pay the indicated percentage of (annual average salary received during the last 3 years of employment, following retirement at or after reaching the indicated age):

- Classic Local Miscellaneous – 2% @ 55
- Classic Public Safety – 3% @ 50
- PEPR Local Miscellaneous – 2% @ 62
- PEPR Public Safety – 2.7% @ 57

For each plan, there is an *Employer Contribution Rate* and an *Employee Contribution Rate* as a percentage of pay. Below are the *Employer* and *Employee* rates set for Fiscal Year 2021/22.

Plan	Employer Rate	Employee Rate
Classic Local Misc.	11.06%	7%
Classic Public Safety	25.59%	9%
PEPR Local Misc.	7.73%	7.25%
PEPR Public Safety	13.98%	13%

The employees pay their rate as a salary deduction. The Town does not participate in Social Security and service to the Town does not constitute quarters earned for the purposes of Social Security benefits. After an employee retires, if they are eligible for Social Security, their Social Security benefit is coordinated with their pension and reduced.

Upon retirement, employees receive benefits based on their respective Plan formula. As an example, a *Classic member* police officer that works solely for the Town for 20 years, retiring at age 50 at an annual salary of \$120,000 would receive \$72,000 per year in retirement ($\$120,000 \times 3\% \times 20$). Benefits are coordinated across multiple public agencies for which the employee worked according to the formulas for those respective agencies. Agencies are only responsible for the time period that the employee worked for their agency, but they are responsible for that time period at the salary at which that employee retired. Benefit calculations are the same for local miscellaneous staff at the lower benefit tiers. For example, a local miscellaneous employee that works solely for the Town for 20 years, retiring at age 55 at an annual salary of \$120,000 would receive \$48,000 per year in retirement ($\$120,000 \times 2\% \times 20$).

Like other pension benefit systems, CalPERS’ system allows for survivor continuance for beneficiaries in the event of the employee’s death. These benefits are calculated by reducing the pension benefit paid while the employee is alive in order to provide a continuation of benefits at a lower amount upon death to a designated beneficiary.

CalPERS conducts Actuarial Reports for each fiscal year that identify the Town’s required contributions to the various Plans. Each plan will have a Net Normal Cost, the basic cost to pay the estimated retirement benefit the active employees earn in that fiscal year, and an Amortization Cost, essentially a debt payment toward the Unfunded Accrued Liability. The Normal cost is added as a percentage of payroll, while the Amortization Cost is a dollar amount that the Town typically makes in a single payment. These two costs combined represent the Employer pension expense and what the Town must pay into each Plan each year. Each cost is determined based on actuarial assumptions related to mortality rates, retirement rates, employment termination rates, disability rates, future investment earnings, inflation, salary growth,

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etc. These assumptions reflect CalPERS' best estimate of future experience of the plan and they are long term in nature. CalPERS' investment strategy reflects a long-term funding horizon of its obligations. So, in theory, if CalPERS' assumptions are accurate, making these payments in full each year, as the Town has always done, should produce declining Unfunded Liabilities.

The Unfunded Accrued Liability is essentially the difference between the Normal Accrued Liability and the Plan's Market Value of Assets. For example, the Town's *Classic* Safety Plan has an Accrued Liability of \$45,702,037. The Market Value of the Assets in the Plan is \$32,008,145. This leaves an Unfunded Accrued Liability or UAL of \$13,693,892. When the Town makes its payment to CalPERS it pays the basic normal cost for active employees (represented as a percentage of payroll) *plus* a dollar payment toward the UAL. It is the growing UAL for each of the Town's plans that is of particular concern.

Finance Committee Review

The Audit and Finance Committee reviewed the most recent CalPERS Actuarial Valuation Reports for the Town's Pension Plans, dated June 30, 2019. Excluding the PEPRA Plans, which are small and nearly fully funded, the reports show the Market Value of Pension Plan assets to be \$45,855,499 against accrued liabilities of \$64,934,851.

Plan	Market Value of Assets	Accrued Liability
Local Safety Plan	\$32,008,145	\$45,702,037
Local Misc. Plan	\$13,847,354	\$19,232,814
Total	\$45,855,499	\$64,934,851

Based on the above asset values, the Town's *Classic* Plans are 71% funded, leaving an unfunded accrued liability of \$19,079,352, an amount that is troubling to say the least. To better understand how this significant liability developed, we have provided some historical data below.

In 2005, for the purposes of calculating future liability, CalPERS merged Plan assets such that the Town's Plan assets are no longer maintained separately from other governmental entities. To accomplish this, CalPERS completed an actuarial valuation to determine each agency's estimated unfunded future liability amount and created a "Side Fund" obligation. The intent of the Side Fund was such that, if an agency maintained its annual required contributions (net normal cost payments), maintained all other things static (number of employees, rates of pay, number of retirees, demographics, etc.), *and* CalPERS' market returns were as projected, when fully paid, the Town's funded status would equal that of the CalPERS overall system at the time, approximately 87%. The likelihood of an employer maintaining the same number of employees, the same rates of pay, while also maintaining the same number of retirees, and the same employee demographic was highly unlikely.

The Town made the required Side Fund payments each year, until making final "balloon" payments in the 2012/2013 fiscal year totaling \$1,871,971. The completion of the Side Fund Payments, in theory, meant the Town should have been nearly 90% funded as of June 30, 2013.

Plan (June 30, 2013)	Market Value of Assets	Accrued Liability
Local Safety Plan	\$24,846,630	\$32,050,359
Local Misc. Plan	\$11,816,121	\$14,539,412

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Plan (June 30, 2013)	Market Value of Assets	Accrued Liability
Total	\$36,662,751	\$46,589,771

However, as shown in the above table, the June 2013 Actuarial Reports indicated that the Town was only 79% funded with an unfunded liability of \$9,927,020.

In FY 2015/16, CalPERS changed its methodology and reduced its amortization period from 30 years to 20 years. While this significantly increased participating agencies' annual costs for the coming decade or more, it was done anyway because of political pressure to adjust local agency costs and reduce the CalPERS earnings rate (discount rate) in the face of the deteriorating pension picture across the entire system. Despite making its Annual Required Payments (Normal Cost) and the required payments toward the UAL, the Town's funded status as a percentage of payroll continued to remain relatively stable at best, or at worst, to decline.

Plan/Year	Market Value (MV)	Accrued Liability (AL)	Unfunded Accrued Liability	% Funded	UAL Payment	Normal Cost
Safety/2015	\$28,263,430	\$36,891,116	\$8,627,686	77%	\$0	\$709,233
Safety/2016	\$27,292,457	\$38,454,832	\$11,162,375	71%	\$325,906	\$487,709
Safety/2017	\$29,968,235	\$41,333,503	\$11,365,268	73%	\$388,638	\$460,440
Safety/2018	\$30,918,059	\$43,955,355	\$13,037,296	70%	\$480,734	\$458,742
Safety/2019	\$32,008,145	\$45,702,037	\$13,693,892	70%	\$607,679	\$437,370
Misc/2015	\$12,571,337	\$15,806,251	\$3,234,914	80%	\$0	\$195,111
Misc/2016	\$12,141,574	\$16,506,054	\$4,364,480	74%	\$116,323	\$157,046
Misc/2017	\$13,504,290	\$17,850,764	\$4,346,474	76%	\$140,897	\$164,695
Misc/2018	\$14,011,196	\$19,118,587	\$5,107,391	73%	\$177,126	\$172,239
Misc/2019	\$13,847,354	\$19,232,814	\$5,385,460	72%	\$230,536	\$186,446

Despite the Town's continued payments toward the UAL, the total dollar amount of its UAL has continued to grow. The Town's Unfunded Accrued Liability from fiscal year 2013 to fiscal year 2019 grew from \$9,927,020 to \$19,079,352, despite the Town meeting its CalPERS obligated payments.

Fiscal Year	Miscellaneous	Safety	Total UAL
2013	\$2,723,291	\$7,203,729	\$9,927,020
2014	\$2,462,836	\$6,777,271	\$9,240,107
2015	\$3,234,914	\$8,627,686	\$11,862,600
2016	\$4,364,480	\$11,162,375	\$15,526,855
2017	\$4,346,474	\$11,365,268	\$15,711,742
2018	\$5,107,391	\$13,037,296	\$18,144,687
2019	\$5,385,460	\$13,693,892	\$19,079,352

The Committee recognizes that the actuarial calculations involved here are complex, involving many ever-changing factors (mortality rates, discount rates, payroll, etc.). It is also true that the Town Plans

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have some unique demographics (average age, ratio of active versus inactive participants, employee demographic, larger retiree base versus active employee base, etc.). In addition, CalPERS has implemented changes over the years that included a rate smoothing policy, changes in actuarial assumptions due to demographics, investment risk volatility, and, most notably, changes in the discount rate. Some of these changes overlap causing huge swings in the actuarial data that are difficult to trace backwards.

Nevertheless, the fact remains that the Town's UAL at June 30,2013 was \$9.9 million and now, just six years later at June 30,2019, and despite meeting its financial obligations to CalPERS, the UAL has ballooned to \$19 million.

The Committee has had two meetings with CalPERS Actuary, Julian Robinson, and he has offered little in the way of good news. In fact, Mr. Robinson projects that pension costs will continue to increase each year for the coming decade. Furthermore, with CalPERS investment returns lagging behind their target rate, further reductions in the discount rate are possible, adding to the scope of our problem.

Committee Recommendation

Based on the scenario described above, the Committee recommends that the Council consider implementing one or more of the options listed, which might offer some relief over time:

1. **Withdraw from CalPERS.** Unfortunately, the termination cost associated with the withdrawal from CalPERS would be astronomical, so this is not a realistic option.
2. **Status Quo.** The Town can continue to make the monthly Net Normal Payments and Annual UAL payments as calculated by CalPERS. This will require larger payments each year for at least the next decade but is projected to eventually result in a lower annual cost and a fully funded plan over the course of time.
3. **Atherton's Pension Trust Fund.** As the Town did for OPEB liabilities, the Town could allocate excess funds as they become available to a separate trust controlled by the Town. However, CalPERS will not credit these amounts in the Trust toward reducing our annual pension costs until the Town actually transfers the funds from the Trust to CalPERS.
4. **Fresh Start with CalPERS.** By contributing additional funds each year directly to CalPERS, the Town could reduce the amortization period for our UAL "debt." This could result in substantial cost reduction over the long term. CalPERS estimates savings of \$6.1 million in interest expense if the Town were to pay off the Safety UAL on a 10-year schedule versus the existing amortization period of 20 years.
5. **Pension Obligation Debt.** The Town's recent experience with funding the Town Center Project could also be applied to the pension situation. In simple terms, the Town is being charged interest on our UAL "debt" by CalPERS at their discount rate (currently 7%), yet in today's market that debt can be offered by the Town to investors at a rate closer to 2%. The difference (approximately 5%) could be used to reduce the annual pension expense. The total cost savings resulting from funding the UAL using this method could be substantial. The debt service on the bond would be less than the projected UAL payment to CalPERS.

Conclusion

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Pension shortfalls are a serious problem everywhere, not just in Atherton. In fact, Atherton is in relatively good shape compared to many municipalities in California and elsewhere. The Town can and will meet its pension obligations. However, given the funding requirements of the Town Center Project, it is unlikely that there will be excess funds available over the next few years to address this issue.

Once funds are available, the Audit and Finance Committee recommends that the Council allocate prudent amounts toward our pension obligations via one or more of the methods discussed above, with particular consideration being given to the issuance of pension obligation debt. Meanwhile, the Committee hopes that the management decisions and investment performance of CalPERS begin to reflect positively in the coming years' Valuation Reports.

Attachment – Facts at a Glance for FY 2018/19

About CalPERS

Board of Administration

CalPERS is governed by a 13-member Board of Administration who are elected, appointed, or hold office ex officio. Read more about it on our website.

State & Federal Legislation

CalPERS' Legislative Affairs Division provides bill analysis and tracks the current status of important state and federal legislation. Read more about it on our website.

Organization

As the nation's largest public pension fund, CalPERS serves more than 2 million members in the retirement system and 1.5 million members and their families in our health program. Read more about our organization in the links below.

- » Benefits Overview
- » Strategic & Business Plans
- » Pension & Investment Beliefs
- » Transparency & Accountability
- » CalPERS History & Story

CalPERS Employers – Retirement Benefits

Total	2,890
State of California	1
Public Agencies	1,570
School Districts & Charter Schools	1,319

CalPERS Employees (for FY 2019-20)

Total number of authorized positions as approved by the CalPERS Board of Administration 2,875

CalPERS Total Budget (for FY 2019-20)

CalPERS total budget (in millions)	\$1,898.1
Subtotal operating costs	\$1,870.6
Administrative operating costs	\$528.8
Investment operating costs	\$120.4
Investment external management fees	\$899.7
Third-party administrator fees	\$321.6
Enterprise project costs	\$3.3
Headquarters building costs	\$24.3

2017-2022 Strategic Plan

The CalPERS Strategic Plan identifies five overarching goals listed below. Read more about it on our website.

-  Strengthen the long-term sustainability of the pension fund
-  Transform health care purchasing and delivery to achieve affordability
-  Reduce complexity across the enterprise
-  Cultivate a risk-intelligent organization
-  Promote a high-performing and diverse workforce



Investment & Pension Funding

Facts at a Glance for Fiscal Year 2018-19

Investments (PERF*)

Total Fund Market Value & Total Net Investment Return** 10-year Review (for FY end 6/30)

	(in billions)	(%)
2019	\$372.6	6.7%
2018	\$354.0	8.6%
2017	\$326.4	11.2%
2016	\$302.0	0.6%
2015	\$301.9	2.4%
2014	\$300.3	18.4%
2013	\$257.9	13.2%
2012	\$233.4	0.1%
2011	\$237.5	21.7%
2010	\$200.0	13.3%

* Public Employees' Retirement Fund (PERF)

** Time-weighted rate of return net of investment expense

Total Net Investment Return*(for FY end 6/30)

FY to date	6.7%
3 years	8.8%
5 years	5.8%
10 years	9.1%
20 years	5.8%
30 years	8.1%

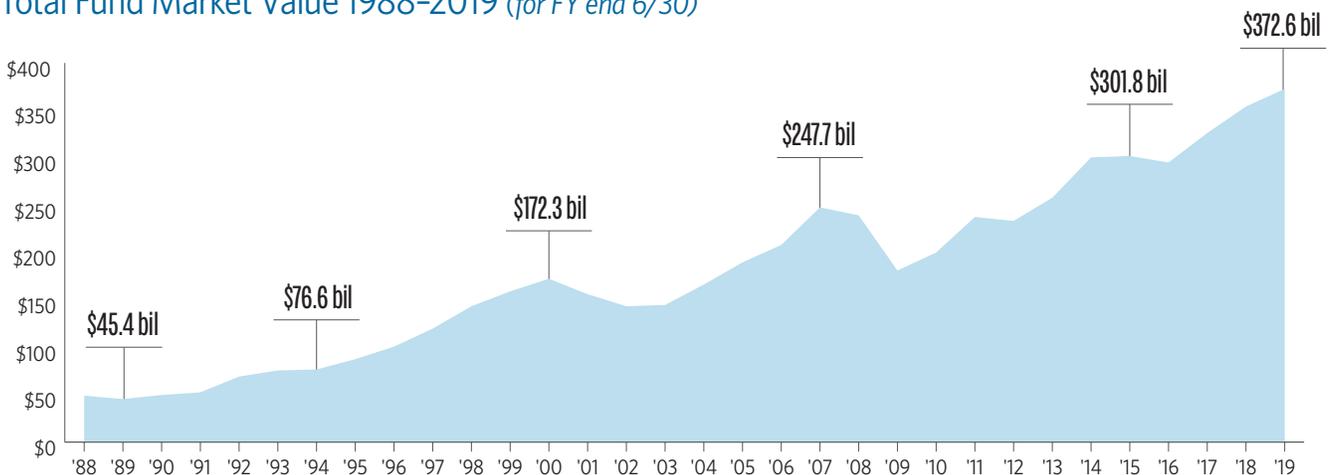
* Net time-weighted rate of returns

Discount Rate Changes

2017-18* (State)	7.5% → 7.375%
2018-19* (School/PA)	7.5% → 7.375%
2018-19* (State)	7.375% → 7.25%
2019-20* (School/PA)	7.375% → 7.25%
2019-20* (State)	7.25% → 7.0%
2020-21* (School/PA)	7.25% → 7.0%
2012	7.75% → 7.5%
2004	8.25% → 7.75%

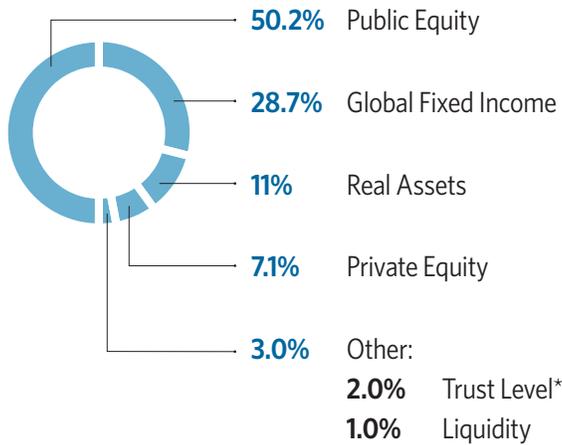
* FY required contribution

Total Fund Market Value 1988-2019 (for FY end 6/30)



Investments (cont'd)

Current Asset Allocation



* The Trust Level includes Multi Asset Class, Completion Overlay, Risk Mitigation, Absolute Return Strategies, Plan Level Transition and other Total Fund level portfolios.

Asset Allocation

	Current Allocation	Strategic Asset Allocation
Public Equity	50.2%	50.0%
Global Fixed Income	28.7%	28.0%
Real Assets	11.0%	13.0%
Private Equity	7.1%	8.0%
Trust Level*	2.0%	—
Liquidity	1.0%	1.0%

* The Trust Level includes Multi Asset Class, Completion Overlay, Risk Mitigation, Absolute Return Strategies, Plan Level Transition and other Total Fund level portfolios.

California Investments



	Fair Value (in millions)
Total California Investments	\$33,953
Public Equity*	\$16,321
Global Fixed Income**	\$5,780
Real Assets***	\$10,950
Private Equity***	\$902

* Includes listed public equities corporate bonds.

** Fixed income also includes a portion of MBS&ABS, which have significant geographical exposure to CA & MHL.

*** As of March 31, 2019

Sustainable Investing

CalPERS actively engages with the companies we own to **protect the long-term sustainability of our investment.**

From issues regarding environmental responsibility to safe labor practices, we keep an open dialog with company leaders and vote our proxies.

11,000+ Number of companies where CalPERS cast proxy votes in 2019 worldwide (calendar year)

Pension Funding

Funded Status of Retirement Plans by Member Category

	State	School	PA	Total
2017-18	69.5%*	68.6%*	70.4%*	69.8%*
2016-17	65.8%*	68.7%*	69.5%*	68.0%*
2015-16	62.3%	67.8%	66.2%	68.3%
2014-15	69.4%	77.5%	74.5%	73.1%
2013-14	72.1%	82.0%	77.9%	76.3%
2012-13	66.1%	76.2%	70.5%	69.8%
2011-12	66.1%	75.4%	70.1%	69.6%

* Based on a 7.0% discount rate and includes the terminated agency pool and 1959 survivor benefit plan.

Contributions, 10-Year Review (in thousands)

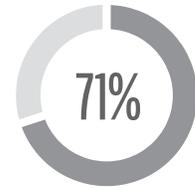
	Employer Contributions	Member Contributions	Investment & Other Income
2018-19	\$15,612,678	\$4,664,618	\$22,969,664
2017-18	\$19,917,796*	\$4,415,129	\$27,448,098
2016-17	\$12,329,837	\$4,214,578	\$32,977,020
2015-16	10,892,489	4,015,754	1,548,442
2014-15	9,997,705	3,826,072	6,702,997
2013-14	8,777,602	3,775,038	45,598,044
2012-13	8,123,833	3,897,078	30,291,983
2011-12	7,772,913	3,598,437	(196,014)
2010-11	7,465,397	3,600,089	43,907,436
2009-10	6,955,049	3,378,867	25,577,529

* Amount includes an additional \$6 billion dollar contribution by the state.

Funded Status Total PERF*



2017-18**



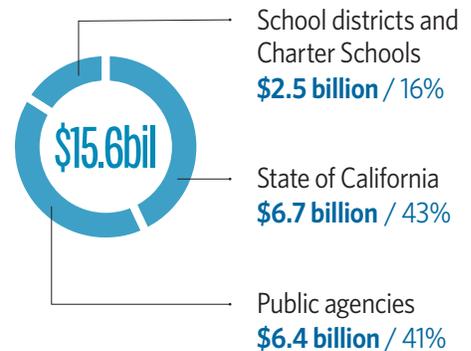
2018-19***

* These totals include Public Employees' Retirement Fund (PERF) and the terminated agency pool and 1959 survivor benefit plan.

** Based on the CAFR for FY 2018-19 using a discount rate of 7.25% for schools, 7% for PAs and state. The funded status is estimated to be 69.8% if using a 7.0% discount rate.

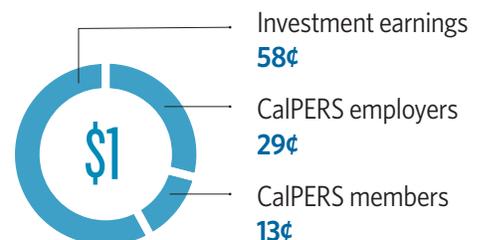
*** Estimate based on using a 7.0% discount rate and includes the additional payments from the state of nearly \$10 billion for the state and school plans.

Total Employer Contributions



Shared Responsibility

Every dollar paid to CalPERS retirees comes from three sources*:

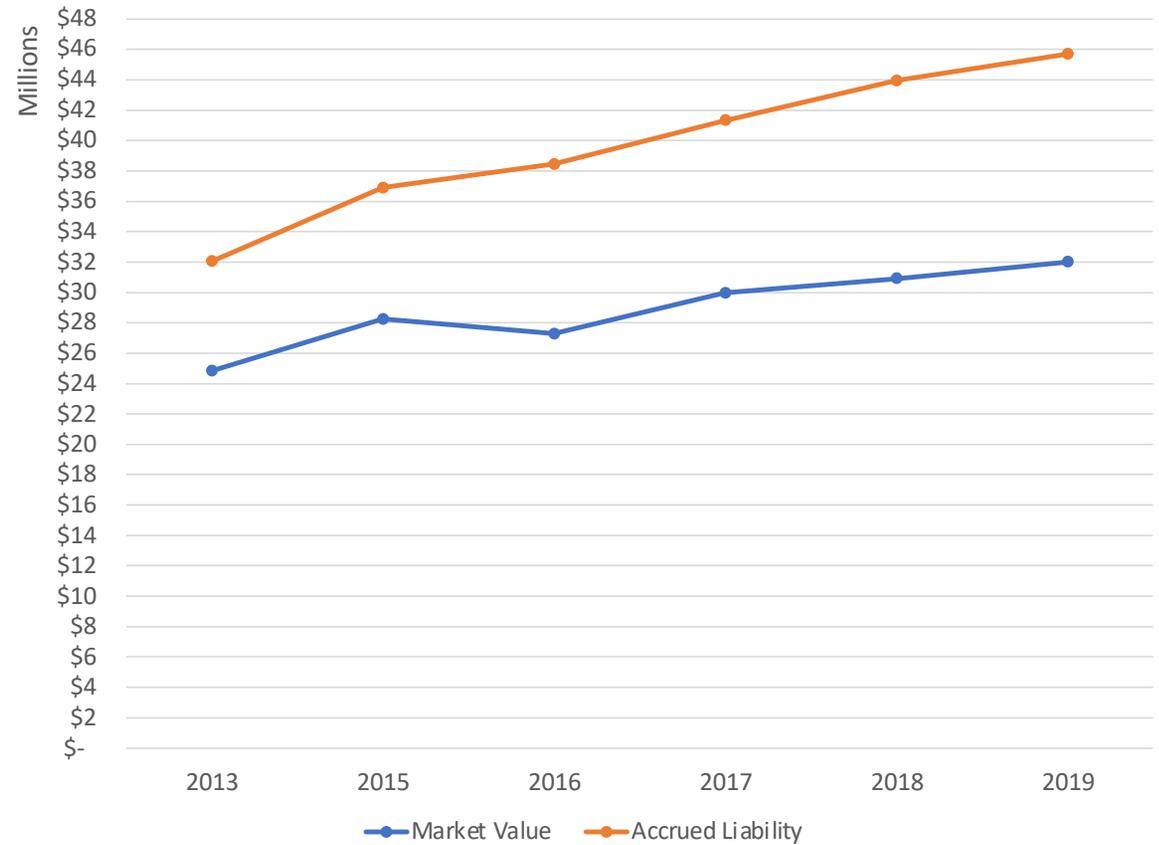


* Income over the last 20 years.

Local Safety Plan

Average Change MV = 3%
Average Change AL = 6%

Market Value v. Accrued Liability



Miscellaneous Plan

Average Change MV = 6%
Average Change AL = 6%

