City of Belvedere – Pension Funding Policy – April 2021

The City of Belvedere is committed to fiscal sustainability. In keeping with this principle, it maintains minimal debt and generous reserves to cope with exogenous shocks. One of the biggest threats to the City's ongoing fiscal sustainability is its rising pension costs. The goal of the City's new Pension Funding Policy is to avoid the risk of crowding out vital public services in future years and to provide balance sheet space to finance essential infrastructure projects in the years ahead by funding its accrued pension obligations at a more prudential rate. Thanks to sensible budget planning, it has the financial resources to do this without negatively impacting service delivery.

The City contracts with the California Public Employees' Retirement System (CalPERS) for its employee defined-benefit pension plans. The City is statutorily required to pay the Annual Required Contribution (ARC) to CalPERS. The ARC comprises two elements; the Normal Cost (NC), which is the annual cost of service accrual, and the Unfunded Accrued Liability (UAL) Payment, which represents the catch-up portion of costs. CalPERS calculates the NC and the UAL based on a 7.0% discount rate, which mirrors its 7.0% expected return on plan assets. The City recognizes that this 7.0% investment target is ambitious and does not align with actual experience nor necessarily expected experience. As losses mount, annual catch-up costs accelerate. To address this shortcoming, the City's Pension Funding Policy comprises the following elements:

Discount Rate: Commencing FY21-22, the City will use a discount rate of CalPERS' expected return on plan assets *minus* 100 basis points to value its pension obligations. This will peg the City's discount rate at 6.0% for FY21-22. Recognizing that CalPERS may reduce its own discount rate in coming years, this 6.0% rate will be fixed until the next standing pension funding review (see later). This approach will facilitate sensible budget planning.

Funding Goal and Timeframe: The City's goal is full funding. It seeks to have assets to cover 100% of accrued pension liabilities valued at a prudential discount rate (putatively "CalPERS minus 100") within 20 years. This calibrates with CalPERS own amortization rules, which allow losses (or gains) to be amortized over 20 years.

Funding Calculation: The City will use CalPERS' Pension Outlook Tool to calculate what the NC and the annual UAL Payment would be if a 6.0% discount rate were applied to the City's four CalPERS' pension plans instead of CalPERS' discount rate. This additional cost will be smoothed over a five-year period, and the annual cost will be included in the City's budget.

Funding Vehicle: The additional funds set aside by the City will be transmitted to a Section 115 pension trust no less than annually. The assets will be managed conservatively, reflecting the City's general risk aversion and pension plan maturity. The City's Finance Committee will establish trust and investment parameters for approval by the City Council.

Trust Seeding: By no later than June 30, 2021, the City will seed the Section 115 Trust with $1.5 million of funds: $1.2 from excess reserves and $300,000 from the City's non-binding pension reserve account, which will be dissolved.

Oversight & Review: The City's Finance Committee will conduct a standing pension funding review at least every five years to reset the discount rate (at an appropriate margin to CalPERS' discount rate based on the latest available evidence), adjust annual funding costs and fix payments until the next review. It may also recommend transferring money from the 115 Trust to CalPERS or making a discretionary payment to the 115 Trust or CalPERS from excess reserves, if any exist at that time. The Finance Committee will send its recommendations to the City Council for approval.

Financial Reporting: The City recognizes the importance of ensuring that pension obligations included in its financial statements, particularly its Comprehensive Annual Financial Report, are consistent with CalPERS and will continue to use CalPERS' discount rate for these purposes. This facilitates easy comparison with other agencies and avoids negative impacts on *perceived* credit quality. The City equally recognizes the importance of communicating its pension stewardship. It will include an annual pension update describing its pension funding policy, trust assets, and adjusted funded status in its annual budget report.

Reserve Requirements: The City maintains a robust minimum reserve policy, with reserves required to equal no less than six months of general fund operating expenses, debt financing costs, and fire contract costs net of fire tax revenues. Transfers to the 115 Trust and Additional Discretionary Payments made to CalPERS will be excluded from the reserve requirement calculation (denominator) because they are discretionary. This is consistent with the City's existing treatment of discretionary payments to CalPERS and internal money transfers.

Fiscal Impact: A 6.0% discount rate reduces the City's funded status with CalPERS from 93.4% to 83.5% and increases its UAL from $1.6 million to $4.5 million as of June 30, 2019 (latest available data). Factoring in a $1.5 million upfront payment to the 115 Trust, annual UAL payments will increase by approximately $210,000 p.a., and the NCR will increase by approximately $90,000 p.a. for the next five years on a smoothed basis, generating a total fiscal cost of $300,000 p.a. The City will terminate its $100,000 annual transfer to its non-binding pension reserve, and the additional $200,000 p.a. will come from a headcount deferral, with no anticipated impacts on service delivery. The City is confident it can continue to meet its reserve requirements.

Employee Contributions: In accordance with PEPRA guidelines and consistent with other local agencies, the City will work to increase Classic employee contribution rates to 8.0% of salary for Miscellaneous employees and to 12.0% of salary for Safety workers. The offsetting reduction in employee costs is excluded from the fiscal impact calculation above.

In sum, the City is fortunate to have the fiscal flexibility to implement a best-in-class pension funding plan, thanks to years of sensible budget planning. The policy formalizes a past practice of using excess reserves to make discretionary payments to CalPERS whenever affordable. The City is committed to honoring its pension obligations and living within its means.

The following five tenets guided the development of the City's Pension Funding Policy:

- The cost of employee benefits should be paid by the generation of taxpayers who receive services.
- Actuarial assumptions should be prudential to ensure that promised benefits can be paid.
- Funding shortfalls should be closed expeditiously. The goal is full funding.
- Large swings in employer contribution rates are undesirable. Smoothing is desirable.
- Funding policies and underlying assumptions should be clearly delineated and regularly reviewed.

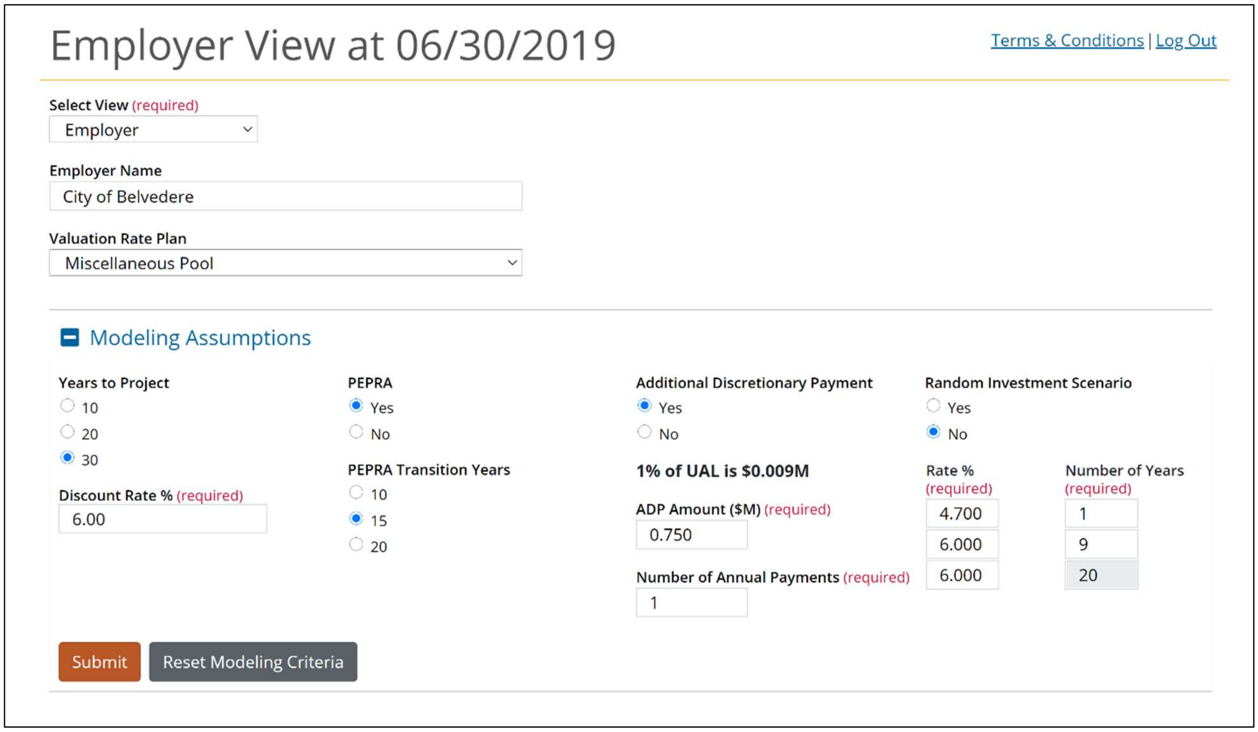
ANNEX

Methodology for Calculating the Impact of a Lower Discount Rate on Annual Pension Costs

The City of Belvedere has chosen to use CalPERS' Pension Outlook Tool to estimate the additional annual pension costs associated with its lower discount rate assumption. The City recognizes the limitations of the tool, notably that outputs are one-year off-cycle and that application of a lower discount rate does not "stick," so the amortization clock restarts every time the model is run. The City is comfortable with these shortcomings, which skew towards modestly overpaying service accrual and UAL amortization costs.

The inputs outlined in Exhibit 1 were used to calculate the increase in costs commencing FY21-22 associated with the City's adoption of a 6.0% discount rate assumption versus CalPERS' 7.0% baseline assumption. The City plans to make a $1.5 million discretionary payment to its Section 115 trust no later than June 30, 2021, which is split 50:50 between Miscellaneous and Safety Pools for modeling purposes. CalPERS generated a 4.7% preliminary investment return for the year ending June 30, 2020, which is used as the Year 1 investment return assumption in the model.

Exhibit 1: Modeling Assumptions



Source: CalPERS' Pension Outlook Tool

The outputs from the model are shown in Exhibit 2. The Normal Cost increases by an average of $90,000 and the UAL Payment by an average of $210,000 per annum over baseline for the five years commencing FY22-23. The City thus intends to transmit $300,000 per year commencing FY21-22 (one year early) to its Section 115 trust for the next five years or until the next pension funding review, whichever is sooner. All things being equal, this same methodology will be applied in conjunction with the next review (using a newly agreed discount rate), and payments will be fixed for a further multi-year period.

Exhibit 2: City of Belvedere Increase in Annual Pension Costs Associated with a 6.0% Discount Rate Assumption

$ millions	Increase in Normal Cost	Increase in UAL Payment	Total Increase
2022-23	0.10	0.19	0.29
2023-24	0.09	0.20	0.29
2024-25	0.09	0.21	0.30
2025-26	0.09	0.21	0.30
2026-27	0.08	0.22	0.30
Average of Period	0.09	0.21	0.30

Source: CalPERS' Pension Outlook Tool