December 2023 Pension Funding Review

Background

In fall 2020, the Finance Committee formed a task force to develop policies to "substantially reduce the City's unfunded pension obligations…to ensure the City's ongoing fiscal sustainability." The Finance Committee's recommended pension funding policy, which was adopted by the City Council in April 2021, can be found here and includes the following:

- Adopting a discount rate 100 basis points lower than that assumed by CalPERS.
- Setting a goal of fully funding the City's accrued pension obligations at this lower discount rate within 20 years.
- Establishing a Section 115 Trust to facilitate additional contributions to achieve this funding goal.
- Seeding the 115 Trust with $1.5 million from existing excess reserves and contributing $300,000 annually starting FY2021/22, paving the way for full funding within 20 years.
- Increasing classic employee contributions to 8% of salary for miscellaneous staff and 12% for safety staff.
- Undertaking a pension review every 3-5 years.

With three years having passed and given CalPERS' volatile investment performance, the Finance Committee agreed to conduct a pension review as part of the FY2022/23 Audit.

Funded Status

At the time of the initial pension review in 2020, the City's unfunded pension obligations officially stood at $4.2 million using CalPERS 7.0% discount rate and $7.3 million using the City's lower 6.0% discount rate (Table 1). Over the past three years, the City's unfunded pension position has improved slightly to $7.0 million (Table 2).

Competing forces have been at work:

1. CalPERS reduced its official discount rate from 7.0% to 6.8%, de facto reducing the City's discount rate from 6.0% to 5.8%. This increased the present value of accrued pension obligations and, thus, the City's unfunded status. (It also increased the City's required contributions to CalPERS, which are projected to rise sharply in coming years.)
2. CalPERS investment returns have been highly volatile, with a positive return of 4.7% in FY19/20, +21.3% in FY20/21, and a net loss of 6.1% in FY21/22. On a compounded basis, this represents slight outperformance versus the City's 5.8% discount rate/investment return assumption. (CalPERS posted a preliminary return of +5.8% in FY22/23.)
3. In October 2020, the City successfully refinanced its lease-leaseback debt at a lower interest rate of 2.55% and reduced the term of the debt. The outstanding balance fell to $1.8 million as of June 30, 2023.
4. As planned, the City has contributed $2.1 million to its 115 Trust as of June 30, 2023. Investment losses and fees have pushed the value of this investment down to $2.0 million as of June 30, 2023 (Table 3).

Overall, the reduction in the City's unfunded pension obligations has been slower than expected but is based on a lower discount rate than initially planned.

Table 1: Belvedere's Net Pension Debt: June 30, 2019

	Entry Age Accrued Liability		Market Value Assets	Unfunded Accrued Liability		Funded Ratio	
Discount Rate	7.0%	6.0%		7.0%	6.0%	7.0%	6.0%
- Non-Safety Classic	$13,537,632	$15,097,391	$12,669,411	$868,221	$2,427,980	93.6%	83.9%
- Non-Safety PEPRA	$233,019	$292,727	$197,432	$35,587	$95,295	84.7%	67.4%
- Safety Classic	$10,012,719	$11,312,843	$9,358,057	$654,662	$1,954,786	93.5%	82.7%
- Safety PEPRA	$94,386	$111,709	$73,010	$21,376	$38,699	77.4%	65.4%
Total CalPERS	$23,877,756	$26,814,670	$22,297,910	$1,579,846	$4,516,760	93.4%	83.2%
PARS[1]	$893,446	$1,006,884	$694,265	$199,181	$312,619	77.7%	69.0%
Lease leaseback[2]	$2,455,000	$2,455,000	-	$2,455,000	$2,455,000	-	-
Total	$27,226,202	$30,276,554	$22,992,175	$4,234,027	**$7,284,379**	84.4%	**75.9%**

1) PARS valuation as of June 30, 2020, using discount rates of 6.5% and 5.5%.
2) Outstanding lease-leaseback debt as of June 30, 2020.

Table 2: Belvedere's Net Pension Debt: June 30, 2022

	Entry Age Accrued Liability		Market Value Assets	Unfunded Accrued Liability		Funded Ratio	
Discount Rate	6.8%	5.8%		6.8%	5.8%	6.8%	5.8%
- Non-Safety Classic	$15,211,269	$16,915,279	$13,299,887	$1,911,382	$3,615,392	87.4%	78.6%
- Non-Safety PEPRA	$651,521	$792,124	$552,280	$99,241	$239,844	84.8%	69.7%
- Safety Classic	$11,087,369	$12,477,229	$9,603,054	$1,484,315	$2,874,175	86.6%	77.0%
- Safety PEPRA	$432,747	$506,183	$357,374	$75,373	$148,809	82.6%	70.6%
Total CalPERS	$27,382,906	$30,690,815	$23,812,595	$3,570,311	$6,878,220	87.0%	77.6%
PARS[1]	$995,424	$1,068,727	$771,200	$224,224	$297,527	77.5%	72.2%
Lease leaseback[2]	$1,842,000	$1,842,000	-	$1,842,000	$1,842,000	-	-
Subtotal	$30,220,330	$33,601,542	$24,583,795	$5,636,535	$9,017,747	81.3%	73.2%
Less 115 Trust Assets[3]	-	-	$2,002,481	-	-	-	-
Total	$30,220,330	$33,601,542	$26,586,276	$3,634,054	**$7,015,266**	88.0%	**79.1%**

1) PARS valuation as of June 30, 2023, using discount rates of 6.5% and 5.5%.
2) Outstanding lease-leaseback debt as of June 30, 2023. 3) 115 Trust valuation as of June 30, 2023

Investment Trust Performance

The poor performance of the City's Section 115 Trust, which has fallen in value over the past three years, is surprising. The funds are invested in CalPERS' CEPPT Strategy 1 Fund, which blends investments in equities, fixed income, and real estate investment trusts. It is a higher-risk fund than CalPERS' CEPPT Strategy 2 Fund and better performing. In the three years to June 30, 2023, the CEPPT Strategy 1 Fund produced an average annualized time-weighted return of 2.7%, yet the City's investment has declined in value. The explanation from CalPERS is that the timing of the City's contributions was suboptimal, often investing high just before a market correction. The initial $1.5 million contribution was spread over time in $100,000 installments. It is unclear if the City can improve the timing of its contributions going forward. Still, the Finance Committee could explore this, and CalPERS has offered to assist in any analysis.

Table 3: Section 115 Trust Performance: CEPPT Strategy 1 (US$)

Quarter Ending	Contribution	Cumulative Contribution	Investment Earnings	Fees	Balance
6/30/2021	200,000	200,000	1,953	-40	201,913
9/30/2021	700,000	900,000	-11,513	-342	890,058
12/31/2021	300,000	1,200,000	33,203	-584	1,222,678
3/31/2022	300,000	1,500,000	-68,217	-720	1,453,741
6/30/2022	300,000	1,800,000	-155,887	-854	1,597,000
9/30/2022	300,000	2,100,000	-105,457	-953	1,790,590
12/31/2022	-	2,100,000	98,450	-1,079	1,887,960
3/31/2023	-	2,100,000	81,143	-1,104	1,967,998
6/30/2023	-	2,100,000	35,615	-1,132	2,002,481

Discount Rate Assumption

In determining whether the City's existing policy of contributing $300,000 per annum to its 115 Trust is likely to be sufficient to eliminate the City's unfunded pension obligations by no later than FY40/41, it is critical to assess whether the City's discount rate/investment return assumption of 5.8% is appropriate. Because of CalPERS' strong performance in FY20/21, average time-weighted returns have increased sharply compared with three years ago (see Table 4). Of course, average returns are sensitive to the date range selected, so, for example, carrying forward the reference period to include CalPERS provisional 5.8% investment return in FY22/23 reduces the 5-year compounded rate of return to 6.1% and the 10-year rate to 6.7%. On balance, the City's 5.8% assumption appears cautious but appropriate.

Table 4: CalPERS' Time Weighted Rates of Return

Year	June 30, 2019	June 30, 2022
1 year	4.7%	6.1%
5 years	6.3%	6.7%
10 years	8.5%	7.7%
20 years	5.5%	6.9%
30 years	8.0%	7.7%

Source: CalPERS

Additional Voluntary Contributions

When the City undertook its initial pension review, it used the CalPERS Pension Outlook Tool to estimate the additional contributions needed to achieve full funding on a 20-year time horizon using a 6.0% discount rate and assuming a $1.5 million upfront 115 Trust payment. The Tool showed a required additional contribution of $300,000 per annum.

Rolling this modeling forward three years and applying a lower 5.8% discount rate and a $2.0 million balance on the City's 115 Trust suggests the City's contribution could be cut to $230,000 per annum starting FY24/25. This would allow full funding in 20 years. However, the initial plan was to achieve full funding by FY40/41, in 17 years (CalPERS Pension Tool does not have sufficient flexibility to finesse the amortization period), suggesting the current $300,000 annual contribution is appropriate and should be extended for the next 3-5 years.

Table 5: Increase in Annual Pension Costs
Associated with a 5.8% Discount Rate Assumption

$ millions	Increase in Normal Cost	Increase in UAL Payment	Total Increase
2025-26	0.09	0.15	0.24
2026-27	0.09	0.14	0.23
2027-28	0.09	0.14	0.23
2028-29	0.08	0.14	0.22
2029-30	0.09	0.14	0.23
Average of Period	0.09	0.14	0.23

The model lags by one year. The change in contributions would take effect FY24/25. Source: CalPERS' Pension Outlook Tool

To achieve full funding more expeditiously, the City could make an additional one-time payment to its 115 Trust using a portion of its FY22/23 excess reserves. It is important to remember that the City's existing unfunded pension obligations are associated with employees' *past service* and should be paid off as quickly as possible.

Employee Contributions

The initial 2020 pension review recommended increasing employee contribution rates to the maximum allowed under the law: from 7% to 8% of salary for Classic Miscellaneous employees and from 9% to 12% for Classic Safety employees. Staff agreed to this increase effective FY25/26.

Considerations

There are myriad factors affecting the size of the City's pension debt that no pension modeling can perfectly predict, including changes to staff composition/headcount, methodological changes, actuarial changes, realized investment performance, and so on. The City's pension funding policy aims to diligently move towards full funding based on reasonable assumptions.

Recommendations

- Continue to apply a discount rate 100 basis points lower than that assumed by CalPERS.
- Continue making Section 115 Trust contributions of $300,000 p.a.
- Consider making an additional one-time payment to the Trust from excess reserves.
- Undertake another pension review in 3-5 years.