CITY OF NEWPORT BEACH
FINANCE COMMITTEE
STAFF REPORT

Agenda Item No. 5D
November 17, 2014

TO: HONORABLE CHAIRMAN AND MEMBERS OF THE COMMITTEE

FROM: Finance Department
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SUBJECT: CalPERS Pension Plan Update and Analysis of Payment Alternatives

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RECOMMENDATION:

Provide staff with policy direction related to the proposed funding options, suggest further changes as needed and if applicable, recommend a funding option for submission to the City Council for approval.

BACKGROUND:

The City of Newport Beach's pensions are pre-funded, as opposed to pay-as-you-go retirement systems like Social Security. In pre-funded systems, the employer and employee make contributions into a pension trust each year, over the course of an employee's working life. That money is invested and earnings on these funds are re-invested. By the time the employee reaches retirement, the accumulated assets in the trust are available to pay benefits. The objective of course, is to accumulate sufficient assets to pay the benefits over the remainder of the employee's life. To meet this objective, a pension plan should receive contributions in accordance with an actuarially based funding policy. The actuarially determined pension funding plan determines exactly how much the employer and employee should contribute each year to ensure that the benefits being earned will be securely funded in a systematic fashion.

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Plan assets come from three distinct sources including employee contributions, employer contributions and investment income.

Since actuarial assumptions are for the long term, demographic and economic assumptions can vary from actual experience. There are many moving parts such as mortality experience, retirement rates, disability incidences, salary growth, investment returns and more. An actuarial plan valuation is therefore prepared each year to true-up contributions levels to better match actual experience.

DISCUSSION:

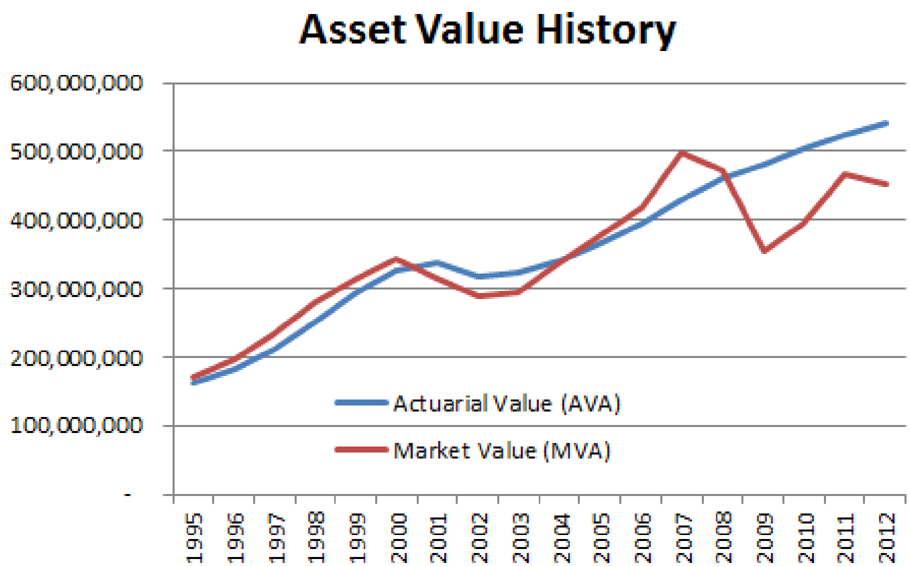
The most recent actuarial report presents the results of the June 30, 2013 California Public Employees' Retirement System (Cal PERS) valuation of both the Miscellaneous and the Public Safety Plans for the City of Newport Beach. This report sets the fiscal year 2015-16 required contribution rates.

Changes Impacting the Valuation Results

On April 17, 2013, the California Public Employees Retirement System (CalPERS) Board of Administration adopted new amortization and smoothing policies. The change became effective with the current valuation (June 30, 2013) that sets the 2015-16 contribution rates. With this change, CalPERS now employs an amortization and smoothing policy that will pay for all gains and losses over a fixed 30-year period with the increases or decreases in the rate spread directly over a 5-year period. Prior to this change, CalPERS employed an amortization and smoothing policy which spread investment returns over a 15-year period with experience gains and losses paid for over a rolling 30-year period. This policy resulted in a negative amortization of the City's unfunded liability (e.g., the unfunded liability would continue to grow year after year under the previous policy).

The former rate smoothing policy also employed the use of an Actuarial Value of Assets (AVA) methodology to set contribution rates. The AVA represented a moving average, of sorts, intended smooth out the everyday ups and downs of the market. While the AVA was known to reduce rate volatility, it also understated the long term funding risk in extreme market conditions. The AVA methodology lagged significantly behind the Market Value of Assets (MVA). During the course of the recession, the AVA strayed so far from the MVA, it became clear that the AVA was no longer a viable option. Despite recent positive investment returns, the elimination of the AVA, created an asset adjustment of nearly $80 million.

The following chart below depicts the two asset values over time and the gap that was created during the past recession.



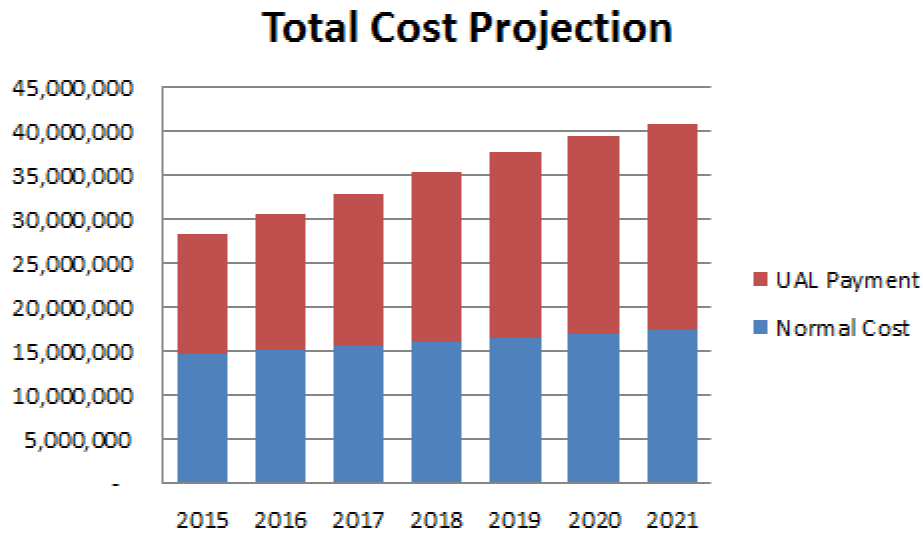
Key Valuation Results

Net of positive investment returns, annual contributions and benefit payments, the City's unfunded pension liability decreased $17 million from $275 million to $258 million despite the $80 million adjustment mentioned above. The components of the unfunded liability are displayed in the following table.

	Miscellaneous	Public Safety	Total
Accrued Liability	$316,856,655	$437,688,131	$754,544,786
Less Market Value of Assets (MVA)	$222,107,686	$274,484,679	$496,592,365
Unfunded Liability	$94,748,969	$163,203,452	$257,952,421
Funded Ratio (MVA/Accrued Liability)	70.1%	62.7%	65.8%

The accrued liability is the value of benefits earned to date by members currently in the plan. When a plan's Market Value of Assets (MVA) is less than its Accrued Liability, the difference is the plan Unfunded Liability. The "Normal Cost" represents the annual pension cost of service for the upcoming fiscal year for active employees. If an Unfunded Liability exists, the plan will have to pay contributions exceeding the normal cost of the plan to pay-down the Unfunded Actuarial Liability (UAL). This amount is associated with past service periods and is due regardless of whether any further service credit is earned. Based on a current attribution analysis of the UAL, 70% of the UAL is attributable to plan participants no longer employed by the City.

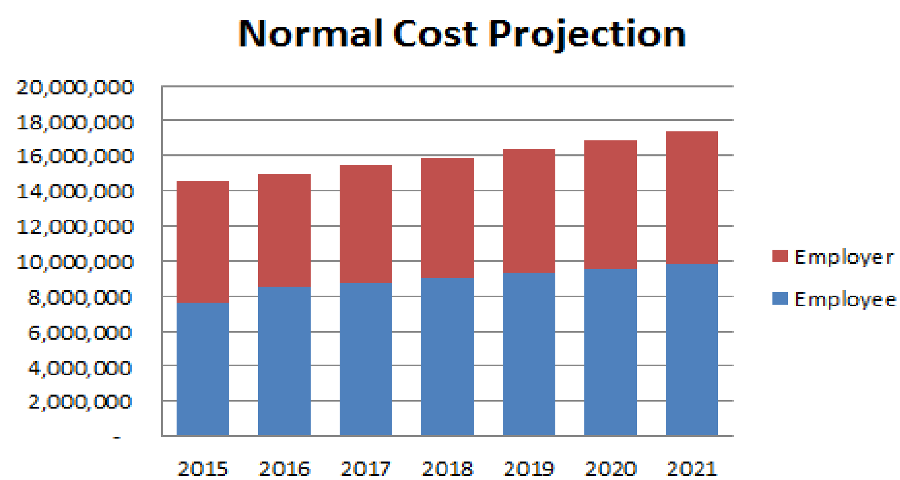
Utilizing the plan's assumed payroll growth of 3% and inclining payment schedules utilized by CalPERS, we expect the total cost of the pension plans to increase as follows:



* Based on zero vacancies and assumed payroll growth of 3%

The chart above also demonstrates that the payment on the unfunded actuarial liability (UAL) represents an increasing portion of the total cost of the pension plans. At the same time, normal pension costs will remain relatively stable.

Employee contributions are also expected to represent a larger percentage of the plan contributions based on current labor contracts and currently exceed 50% of the normal plan costs as is demonstrated by the chart below:



* Based on zero vacancies and assumed payroll growth of 3%

Impact of New Asset Smoothing Methodology

On April 9, 2013, the City Council approved a fresh start fixing the payment schedules to 21 years for Miscellaneous and 26 for Safety. Two years later, our remaining amortization period should have been 19 years and 24 years for the respective plans. Unfortunately, the $80 million AVA adjustment was added to our unfunded liability payment schedule to be amortized over a fixed 30 year period which will slow our pension funding progress, in spite of our prior fresh start. On a weighted average basis, the remaining amortization period is now 22.9 years for Miscellaneous and 25.7 years for Safety.

Options for Funding of the UAL Faster

It is the City's policy (See Reserve Policy F-2) to: 1) amortize the unfunded actuarial liability in accordance with the actuary's funding recommendations; and 2) make effort at maintaining its UAL within a range that is considered acceptable to actuarial standards. Our actuary indicates that an 80% funded ratio is a good target, leaving room for market value adjustments in either direction. Policy F-2 further prescribes that the City Council shall consider increasing the annual CalPERS contribution should the UAL status fall below acceptable actuarial standards.

The City has taken a number of actions to mitigate the rising costs including:

- Establishing lower benefit formulas for new hires
- Eliminating the Employer Paid Member Contribution (EPMC)
- Having employees pay more of the pension costs.
- Reducing the number of staff by nearly 100 employees
- Adopting a fixed and shorter amortization period of the unfunded liability

Investment returns have been promising as of late but are not likely to eliminate our unfunded liability without further action. Significant savings will accrue to the City as the result of previous Council actions but the current UAL will take more than two decades to fully be eliminated under the current payment schedule.

A more immediate approach at addressing the escalating nature of UAL costs and to bring the City's funded status higher than the current funded ratio of 65.8% is to accelerate our payments on the UAL, similar to paying a mortgage or car payment quicker. Nearly two years ago, the City accelerated its UAL payment schedule by increasing its payments to CalPERS. In doing so, the Council set a course to reduce interest by $113 million over the next 30 years. As previously stated, the new asset smoothing policy employs a 30 year fixed amortization with a 5 year ramp up. The 5 year ramp effectively defers the full cost of the UAL over time. By paying the full amount sooner and shortening the amortization period, the City can realize significant additional savings.

The City again has an opportunity to accelerate the payment of the UAL from the current 30-year plan. Staff evaluated various funding options to accelerate the repayment of the unfunded liability and achieve significant plan savings. As directed by Chairman Henn, staff evaluated the option to repay both plans over a fixed 19 year, 15 year and 10 years periods as compared to the current schedule. The table below summarizes and compares the funding requirements and potential savings of year funding option.

	Unfunded Liability Payment Savings (Millions)			
	Payment Schedule			
	Current	19 Yr	15 Yr	10 Yr
Projected Unfunded Liability - 6/30/15	273	273	273	273
Total Payment Requirement	664	535	465	390
Gross Payment Savings	N/A	129	198	274
NPV Savings @ 3%	N/A	47	76	109

Each of the scenario options will result in lower interest payments and greater long-term savings. Related cash flows can be found on page 2 of Attachment A.

Current 30-Year UAL Payment Plan (Current)
Under the current 30-year plan presented in the latest valuation, the City will pay down the UAL over 30 years at a net present value cost of $440 million (including interest). Under this plan, the City will reach an 80% funded status in 2021 (Miscellaneous Plan) and 2027 (Public Safety Plan).

Scenario 1: 19-Year UAL Payment Plan - Recommended
Under the 19-year payment plan, the City will pay down the UAL at a net present value cost of $375 million (including interest) and realize present value savings of $47 million from the 30-year plan. Under this plan, the City will reach an 80% funded status in 2020 (Miscellaneous Plan) and 2024 (Public Safety Plan). On average this option will require additional funding of $5 million for the first 4 years and an average of an additional $3 million for the remaining years when compared to the current payment plan. From a cash flow perspective, staff recommends this as a financially sustainable option when compared to the scenarios that follow. It achieves significant return on investment with relatively low incremental cost.

Scenario 2: 15-Year UAL Payment Plan – More Savings But Twice the Cash Flow
Under the 15-year payment plan, the City will pay down the UAL at a net present value cost of $364 million (including interest) and realize present value savings of $76 million from the 30-year plan. Under this plan, the City will reach an 80% funded status in 2020 (Miscellaneous Plan) and 2023 (Public Safety Plan). On average this option will require additional funding of $9 million annually for the first 4 years and an average of an

additional $8 million for the remaining years when compared to the current payment plan.

<u>Scenario 3: 10-Year UAL Payment Plan- Extremely Aggressive</u>
Under the 10-year payment plan, the City will pay down the UAL at a net present value cost of $330 million (including interest) and realize present value savings of $109 million from the 30-year plan. Under this plan, the City will reach an 80% funded status in 2019 (Miscellaneous Plan) and 2021 (Public Safety Plan). On average this option will require additional funding of $18 million annually when compared to the current payment plan.

Summary

CalPERS acts as an investment and administrative agent for the City's pension assets and recognizes that a long time investment horizon is a responsibility and an advantage. While accelerating UAL payments increases the City's exposure to market risk, doing so in an orderly "dollar cost average" basis as proposed in the accelerated payment scenarios above is an accepted method of mitigating market risk and lowering the City's pension costs.

There are two options for an accelerated UAL pay down. The first is known as a "Fresh Start" which pays down the UAL sooner and saves significant interest costs. The City employed a Fresh Start in 2013 and in doing so changed the amortization methodology from a rolling 30 year basis to a fixed declining basis. This methodology decreases interest costs by paying down principal sooner rather than deferring payments down the road. However, like any fixed mortgage rate, there is no flexibility in contributing lower payment amounts. The second alternative is known as "Additional Discretionary Payments (ADP)" which allows agencies to contribute any desired amount above the minimum payment, thereby providing more flexibility should the City find itself cash constrained in any down year. The City's actuary, credit rating agencies and staff believe that electing to pay the unfunded liability on a discretionary basis is the preferred method because the City preserves its budget flexibility in the event of an economic down.

Using cash now to pay off the UAL also has an opportunity cost. What services, programs, facilities, or beautification might the community desire now that would be foregone due to the commitment of cash for this purpose? Staff recommends scenario 1, the 19 year payment amortization. This plan produces significant long-term savings at a relatively low incremental cost. Staff proposes that the incremental cost of the first year could come from the FY 2013-14 operating surplus and future contributions could come from future anticipated revenue growth and future operating surpluses until the incremental cost can be fully absorbed into the operating budget. This initiative would have no foreseeable impact on the Facilities Financial Plan as currently contemplated.

Staff requests that the Finance Committee provide policy direction related to the proposed funding options, suggest further changes as needed and if applicable, recommend a funding option for submission to the City Council for approval.

Prepared by: Submitted by:

/s/ Steve Montano

Steve Montano
Deputy Finance Director

/s/ Dan Matusiewicz

Dan Matusiewicz
Finance Director

Attachments:

A. Analysis of Unfunded Pension Liability Funding Options
B. Annual Valuation Report as of June 30, 2013 – Miscellaneous Plan
C. Annual Valuation Report as of June 30, 2013 – Safety Plan