CITY OF NEWPORT BEACH
FINANCE COMMITTEE
STAFF REPORT

Agenda Item No. 5A
November 14, 2019

TO: HONORABLE CHAIR AND MEMBERS OF THE COMMITTEE

FROM: Finance Department
Dan Matusiewicz, Finance Director
949-644-3123 or danm@newportbeachca.gov

SUBJECT: PRELIMINARY PENSION FUNDING RECOMMENDATION – FISCAL YEAR 2020-21

SUMMARY:

Each year, staff analyzes the most recent California Public Employees' Retirement System (CalPERS) pension actuarial valuations and evaluates opportunities to more efficiently amortize the City's unfunded accrued liability (UAL) compared to the default minimum contribution schedules proposed by CalPERS.

Staff has evaluated the merits of pursuing the default payment option, three additional direct payment options to CalPERS. Staff recommends a prefunding option that assumes five years of $5 million of additional discretionary payments above the current $35 million self-imposed threshold, followed by $2 million additional for the remaining 15-year term. This provides a $77 million buffer against future investment losses.

See the proposed payment option comparisons in Attachments A-1 and A-2

RECOMMENDED ACTION:

Provide feedback regarding staff recommendations.

DISCUSSION:

PENSION PLAN HEALTH STATUS

The City's pension obligations are and will continue to be one of the City's largest financial concerns for decades to come so it is important that it receives appropriate and regular attention. With its current participants and benefit levels, the City's accrued pension liability (AL) now exceeds $1 billion dollars and has been growing at an annual rate of 6.6% for the last eleven years. Meanwhile, General Fund revenue has only grown 3.4% annually for the same eleven-year period (2007-2018). The City's AL now represents 467% of annual General Fund revenues as compared to the County wide average of about 515% as of June 30, 2018. This gap will likely continue to widen over the next two decades. As these growing leverage ratios continue to expand, investment losses can have devastating impacts on local agency budgets.

The City's current Unfunded Accrued Pension Liability (UAL) grew by $13.5 million or 4.2% to $333 million as of June 30, 2018. This number is significant but is largely what staff expected and is already factored into the current budget and long-range pension funding plan. Plan assets and liabilities are displayed in the table below.

3 YEAR UAL TREND

	2016	2017	2018	Change	
	Total	Total	Total	Dollars	Percent
Accrued Liability (AL)	887,481,877	939,503,861	1,006,978,316	67,474,455	7.2%
Less: Market Value of Assets (MVA)	566,016,065	619,834,899	673,843,069	54,008,170	8.7%
Unfunded Accrued Liability (UAL)	321,465,812	319,668,962	333,135,247	13,466,285	4.2%
Funded Status	63.8%	66.0%	66.9%		

Staff estimated the liability would grow to $325 million due to a .25% reduction in the discount rate which is now at 7%. The $8 million difference between estimated UAL and actual UAL at June 30, 2018 is due to other changes in actuarial methods and demographic experience that staff had not anticipated. Some good news is that as the UAL is rolled forward from June 30, 2018 to June 30, 2020 for the development of the minimum required contribution for FY 2020-21, the City's UAL drops back down to $318 million reflecting the additional discretionary payments (ADP) paid during FY 2018-19. Prior to the end of the current fiscal year, we anticipate the UAL will continue to drift downward to $311 million to reflect ADPs being paid in FY 2019-20 that are not included in the 2018 actuarial valuation yet.

In relation to the other CalPERS agencies in Orange County:

- The City's 2018 UAL of $333 million grew by the lowest rate in the County (4%) as compared to the County average of 10%.
- The City is only one of two local agencies in the County where the funded status actually increased from 2017 to 2018. This means that the City's assets grew at a faster rate than the accrued pension liability.
- The City is only one of four cities in the County whose UAL is projected to decrease through 2020.
- The City developed the most efficient payment plan in the County. Where most agencies' interest payments represent 46% of total planned payments, the City's interest payments are down to 38% of total scheduled payments.

The Comparison of Pension Progress Table is included as Attachment A.

The City's funded status is still improving, despite the scheduled .25% reduction in the discount rate. The overall plan funded status of 67% is still relatively low but is forecasted to improve dramatically over the next decade barring adverse investment results or further changes in actuarial assumptions. The City Council has been proactive and aggressive in addressing the ongoing pension crisis. By proactively managing the repayment of the unfunded pension liability and influencing CalPERS policies, the City is well positioned to weather the pension challenges known today.

The most recent actuarial report presents the results of the June 30, 2018, CalPERS valuation of both the Miscellaneous and the Public Safety Plans for the City of Newport Beach and sets the required contribution amounts and rates for FY 2019-20. After adding in ADPs and deducting negotiated employee contributions, FY 2020-21 pension costs are estimated as follows:

	Normal Cost Rate		Expected Normal Cost		Change	
	2019-20	2020-21	2019-20	2020-21	Dollars	Percent
Misc	16.9%	17.7%	7,712,921	7,747,118	34,197	0.4%
Safety	28.1%	29.2%	9,694,973	10,160,422	465,449	4.8%
Total Normal Expected Cost			17,407,894	17,907,540	499,646	2.9%

	Amortization of UAL		Change	
	2019-20	2020-21	Dollars	Percent
Minimum Unfunded Liability Contribution	26,196,003	29,753,088	3,557,085	13.6%
Additional Discretionary Payment (ADP)	8,803,997	5,246,912	(3,557,085)	-40.4%
Total Planned UAL Payment	35,000,000	35,000,000	-	0.0%

	Total Expected Pension Cost		Change	
	2019-20	2020-21	Dollars	Percent
Total Expected PERS Contribution	52,407,894	52,907,540	499,646	1.0%
Less: Expected Employee Contributions	10,632,010	11,258,628	626,618	5.9%
Net Employer Cost "Projected"	$ 41,775,884	$ 41,648,912	$ (126,972)	-0.3%

The current strategy is to make level dollar payments of $35 million a year towards the $311 projected UAL until it is paid off in fourteen years.

WHAT SHOULD WE EXPECT IN THE 2019 ACTUARIAL VALUATION?

In the 2019 actuarial valuation we should expect continued improvement in the funded status and nothing dramatically adverse that might necessitate a change in our strategy or required payment. The Public Employers Retirement Fund (PERF) earned 6.7%, an experience loss of .3% or $2.2 million for the City. However, the price inflation assumption of 2.5% is higher than the actual inflation rate of 1.65% - a favorable liability experience gain of .85%. While we are reluctant to estimate a value of this gain, it is likely the two experiences will offset each other barring other unfavorable changes in demographic experiences. Staff does not recommend a strategy adjustment as a result of FY 2018-19 experience at this time.

CAPITAL MARKET ASSUMPTIONS DO NOT BODE WELL IN THE NEAR-TERM

While economist are not predicting a recession in the next year, favorable investment results do not appear likely in the near term. At this year's Economic Forum, UCI's

Associate Professor of Finance, Dr. Christopher Schwarz summed up his remarks this way:

- Expect slower [GDP] growth in 2020 and beyond (1.5% is the new normal)
- The Federal Reserve will be the economy's friend (implying lower interest rates)
- Asset prices are high = correlated low returns going forward

Consistent with his remarks and as illustrated in the chart below, only one asset class (Private Equity) is predicted to exceed the target investment return of 7%. With CalPERS' target asset allocation of 50% to Global Equity, 28% to Fixed Income, 13% to Real Assets, 8% to Private Equity and 1% to Liquidity, it is hard to imagine a path forward that would produce an investment return that meets the 7% target return.

Expected CalPERS Investment Return by Asset Class

Persistent returns below 7% will require the City to consider additional capital infusions if the City is to meet its goal of paying down the UAL in 14 years.

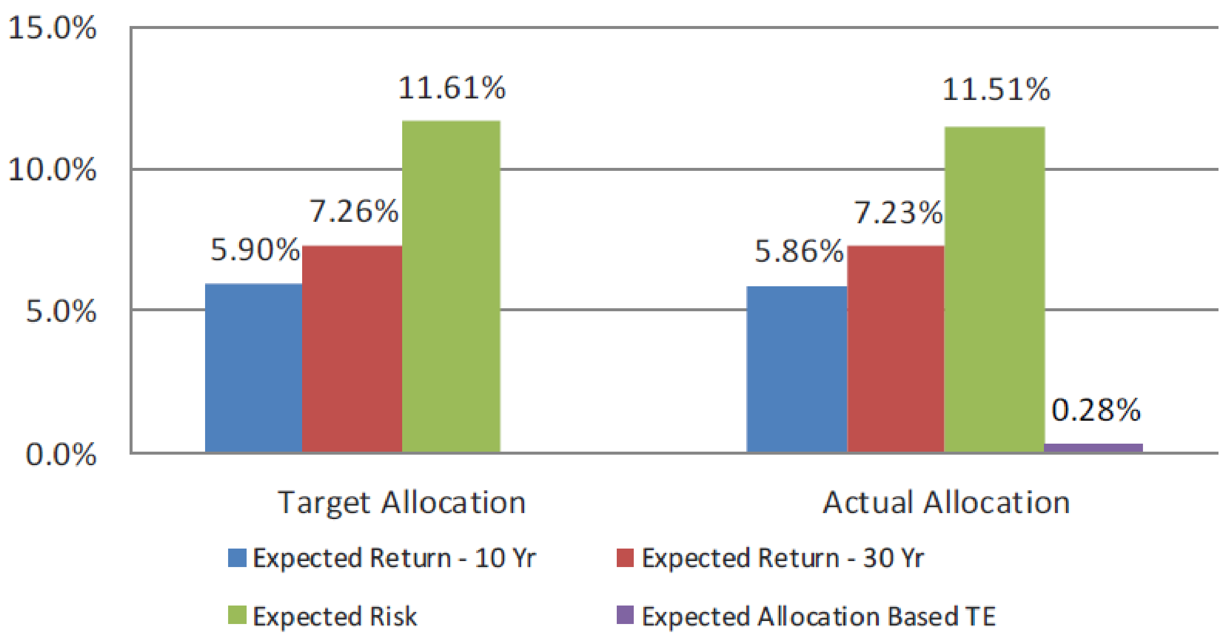
PREPARING FOR VOLATILE MARKETS AND SLOW GROWTH

Since nearly 60% of the pension benefits are provided by investment results, City pension plans are extremely sensitive to investment earnings. With over $700 million in plan assets, a 1% investment experience loss equates to approximately $7 million loss for the City. Due to these low capital market assumptions (CMA's) and CalPERS' current asset allocation, 68% of all investment results can vary 11.51% from the mean expected return of 7% in any one year resulting in an experience loss of approximately $83 million. In a more extreme year, one can expect 95% of investment results to vary as much as 23% (a $165 million loss) for the City's pension plans.

While expected year-to-year volatility can be rather frightening, good and bad years are expected to even out over time. CalPERS Chief Investment Officer, Dr. Ben Meng encourages employers to "Stay calm and carry on." While this is sound advice, I believe it is also prudent to take measured steps to prepare for lower than expected returns and insulate the City's budget where possible.

The chart below illustrates the PERF portfolio's expected risk reward assumptions over the near and long-term. Good and bad years are averaged out for a net positive return of 5.86% in the near/intermediate term and improve to 7.23% over a 30-year horizon. However, 5.86% is still well short of the expected return of 7%. While CalPERS is a long-term investor with a very long investment horizon, 5-10 years is a long time with respect to municipal budgeting. With the prospect of adding to the 2008 losses, that most local agencies are still struggling to pay off, it is likely that pension costs will continue to have adverse effects on local agency budgets for decades to come.

CalPERS Expected Risk and Return Estimates

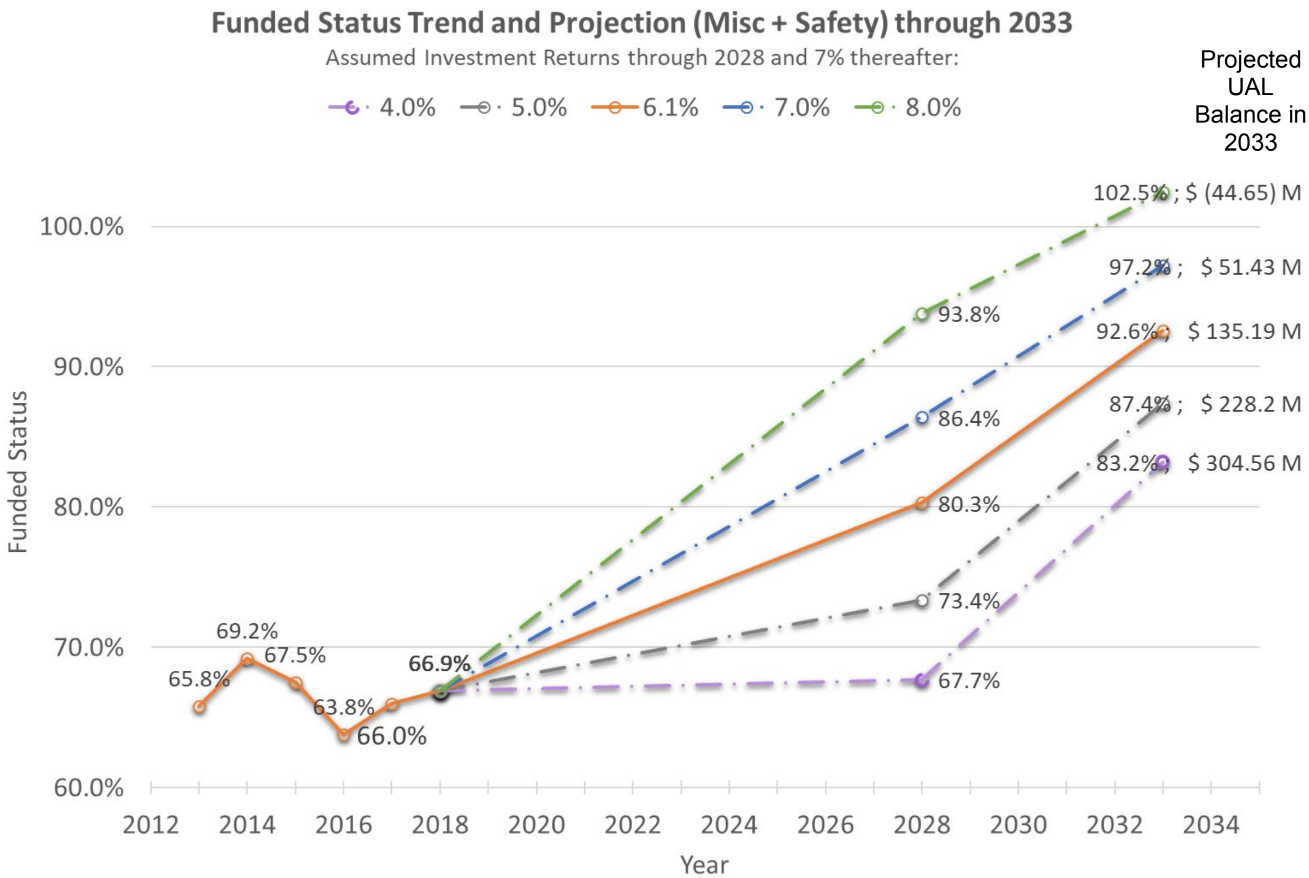


Source: Wilshire Consulting

While the chart above suggests an expected return of 5.86% for ten years, market projections beyond 5 years may likely rely on more art than science. However, the City should consider the impact that a low market growth investment environment would have on the City budget.

With the assistance of a CalPERS actuary, staff stress-tested our plans illustrating the impact of various geometric returns including 4%, 5%, 6.1%, 7% and 8% for a ten-year period of time and then assumed 7% for 5 years thereafter. We used 6.1% as our baseline projection because it was the last official CalPERS projection that resulted from their 2017 Capital Market study.

The good news is that in all scenarios, the funded status of the plans improved even when investment returns below the 7% target are assumed. The bad news is that after 15 years, the UAL accumulates to sizable balances that are likely unacceptable to the community. The chart below illustrates the trajectory of the plan funded status at the 10 and 15 year milestones. The reason the funding status is improving relatively sharply even in the low investment return scenarios is that the 2013 Fresh Start base starts to rapidly pull down principal as this base matures off our UAL amortization schedule.



The next question is how should the City best insulate itself from expected investment returns below the target rate of 7% or whether it should take no action at all and pay-as-you-go as losses occur. Because of the high cost of waiting due to interest accruing at 7%, staff recommends the City start prefunding expected losses based on the answer to four variables:

1. What rate of average shortfall should the City prepare for (e.g., 1, 2 or 3%)?
2. How long will the shortfall persist (e.g., 1-10 years)?
3. Over what period of time would the City like to prefund expected losses (10, 15 or 20 Years)?
4. How much is the City willing to contribute above the current contribution level?

To help facilitate a response to these questions, staff prepared a table included as Attachment B that provides decision makers some guidance as to the scale of the loss and the annual prefunding amounts that would be necessary if the City chooses to get ahead of expected losses.

The excerpt of Attachment B below helps decision makers understand the magnitude of persistent investment shortfalls and amounts needed to prefund potential shortfalls over various time horizons.

			Expected Shortfall		Repayment Term		
					Aggressive	Less Aggressive	Min
CMA Outlook Term	Yrs	Projected Plan Assets	1.0%	Cumulative Shortfall + Interest	10	15	20
	1	718,990,555	7,189,906	7,189,906	545,483	308,898	195,454
	2	762,129,988	7,621,300	15,314,499	1,161,880	657,953	416,318
	3	807,857,787	8,078,578	24,465,092	1,856,117	1,051,088	665,073
	4	856,329,254	8,563,293	34,740,941	2,635,724	1,492,567	944,417
	5	907,709,010	9,077,090	46,249,896	3,508,885	1,987,023	1,257,283
	6	962,171,550	9,621,716	59,109,105	4,484,487	2,539,491	1,606,855
	7	1,019,901,843	10,199,018	73,445,761	5,572,180	3,155,433	1,996,590
	8	1,081,095,954	10,810,960	89,397,923	6,782,438	3,840,782	2,430,243
	9	1,145,961,711	11,459,617	107,115,395	8,126,626	4,601,973	2,911,885
	10	1,214,719,414	12,147,194	126,760,667	9,617,073	5,445,989	3,445,933

As an example, if the PERF on average falls short of their target by 1% for five years, the cumulative loss with interest accruing at 7% amounts to $46 million. This anticipated loss can be prefunded by 10 annual payments of $3.5 million assuming the PERF earns 6%. Similarly if the 1% average shortfall persists for 10 years, the cumulative loss plus interest accumulates to $126 million at 7%. This loss can be prefunded by 10 annual payments of $9.6 million and so forth.

FUNDING OPTIONS

Staff further prepared amortization schedules with and without the optional prefunding of expected investment losses. Amortization schedules without prefunding expected investment losses can be found in Attachment C.

Standard Funding Options (SFO)

SFO 1 - Assumes the default repayment schedule with no further ADPs.

SFO 2 - Assumes ADPs that bring the UAL payment up to but not exceed $35 million.

SFO 3 - Assumes the City will be amenable to a one-time contribution of $5 million over the $35 million threshold in FY 2020-21. As a source of proceeds, staff proposes using 50% of FY 2018-19 annual surplus as was contemplated by Council Policy F-5, General Fund Surplus Utilization.

Anticipatory Prefunding Options to Mitigate Persistent Investment Shortfalls

"*A good hockey player plays where the puck is. A great hockey player plays where the puck is going to be." Wayne Gretzky*

Staff also prepared three additional amortization schedules assuming some level of prefunding of future expected investment experience losses. While the anticipated losses are not built into the UAL balance Anticipatory prefunding can help the City in two ways. It could act as buffer against adverse investment results especially if they are persistent. It could also act as a baby step toward realigning our budget toward further reductions to the assumed discount rate which I believe to be inevitable. Based on my discussions with CalPERS leadership over the years, I know it is their strong preference to lower the discount rate which paves the way to reduce volatility risk in the investment portfolio. Their dilemma is that many local agencies are still struggling to pay off the 2008 investment losses. These losses are still escalating pension costs for many local agency budgets through 2025 that have not taken aggressive actions as this Council has. Below you will find three options that could help the City insulate itself against persistent investment earnings shortfalls, a catastrophic investment loss or that baby step toward lower discount rates expected in the future.

APO 1 - Assumes discretionary prefunding of an additional $2 million per year above the $35 million threshold. This would provide for five years of 1% investment shortfalls repaid over 15 years or until the UAL is paid off. This option provide a $46 million buffer against future losses.

APO 2 - Assumes five years of $5 million of additional discretionary payments above the $35 million threshold, followed by $2 million additional for the remaining term. This provides a $77 million buffer against future investment losses.

APO 3 - Option 3 is the most aggressive and assumes $5 million of additional discretionary payments above the $35 million threshold until the UAL is paid off (over the next 15 years). This provides for a $116 million buffer against future persistent or catastrophic investment losses.

Below is a sample illustration how prefunding dollars could accumulate and compound over time:

	Investment Loss Risk Mitigation		
	Prefunding Options		
	Option 1	Option 2	Option 3
1	2,000,000	5,000,000	5,000,000
2	2,000,000	5,000,000	5,000,000
3	2,000,000	5,000,000	5,000,000
4	2,000,000	5,000,000	5,000,000
5	2,000,000	5,000,000	5,000,000
6	2,000,000	2,000,000	5,000,000
7	2,000,000	2,000,000	5,000,000
8	2,000,000	2,000,000	5,000,000
9	2,000,000	2,000,000	5,000,000
10	2,000,000	2,000,000	5,000,000
11	2,000,000	2,000,000	5,000,000
12	2,000,000	2,000,000	5,000,000
13	2,000,000	2,000,000	5,000,000
14	2,000,000	2,000,000	5,000,000
15	2,000,000	2,000,000	5,000,000
Sum of Payments	30,000,000	45,000,000	75,000,000
With 6% Interest	46,551,940	76,837,465	116,379,849

STAFF RECOMMENDATION:

Due to the leverage risk associated with the accrued liability dwarfing annual General Fund revenues by nearly 500% and the dismal CMA outlook in the near term, staff recommends Prefunding Option 2. Staff proposes to monitor the results of the next CMA study due to start in June of 2020 and revaluate progress and options each year. The City has routinely produced significant annual surpluses. However, if resources are not available, the City is not obligated in any way to continue prefunding but staff would also recommend the Council consider drawing down the contingency reserve as necessary to continue to the prefunding effort.

If investment shortfalls do evolve as forecasted the City will be better prepared for future pension cost increases. If investment shortfalls do not come to pass, the pension plan will simply become better funded sooner rather than later and save millions in interest in the process.

If the discount rate is lowered in the future, which is a distinct possibility, the City will be better prepared to absorb those costs. The downside is that further pension contributions could further constrain the City's ability to undertake community projects or programs.

Prepared and Submitted by:

/s/ Dan Matusiewicz
Dan Matusiewicz
Finance Director

Attachments:

Attachment A: Comparison of Pension Funding Progress Table
Attachment A-1: Standard Funding Options Summary
Attachment A-2: Anticipatory Prefunding Options Summary
Attachment B: Investment Loss Prefunding Table
Attachment C: 2020-21 Standard Funding Options 1-3
Attachment D: Anticipatory Prefunding Options 1-3