Agenda Item #3.1
For Council Meeting of: August 6, 2013

CITY OF SANTA ROSA
CITY COUNCIL

TO: MAYOR AND CITY COUNCIL
SUBJECT: ACTUARIAL REVIEW OF CITY PENSION PLANS
STAFF PRESENTER: KATHY MILLISON
CITY MANAGER

AGENDA ACTION: NO ACTION REQUESTED

BACKGROUND

The purpose of the study session is to review the actuarial report prepared for the City by an independent actuary, Bartel Associates LLC, which specifically examines the demographics of the City's employee population, the financial status of the City's California Public Employees Retirement System (CalPERS) account at a specific point in time, and the impact of a variety of changes to the plan enacted since the prior actuarial report completed in 2011 or changes anticipated to be enacted in 2014. The City periodically authorizes such independent actuarial reports to assist with its financial planning and budget policy.

The State and CalPERS have enacted changes in the last 12 months that will significantly impact the City's CalPERS rates through fiscal year 2019/20 and going forward. CalPERS will likely make additional changes this fiscal year that will further impact rates going forward.

During this study session, Mr. Bartel will identify the impact the following actions have had on the City's CalPERS rates:

1. Changes in pension formulas made by both the City and the State
   - On July 8, 2011 the City enacted a second tier retirement formula for new employees.
   - On January 1, 2013 the state legislated pension changes including a new tier of retirement formula for employees newly entering CalPERS through the Public Employee Pension Reform Act (PEPRA).

2. Changes in CalPERS' calculation of amortization and smoothing rates. On April 17, 2013 (per attached Circular) the CalPERS Board voted to employ an amortization and smoothing policy that pays for all gains/losses over a fixed 30 year period with the increases or decreases in the rate spread directly over a 5-year period. The change is intended to establish rates that balance the need to

address the increase in unfunded plan liabilities, recognize current market valuation of the fund, and manage future volatility of the rates.

Mr. Bartel will also identify the impact of future changes CalPERS will consider in January, 2014: a reduction in the discount rate (the assumed rate of investment earnings); and, a change in assumptions regarding generational mortality (longevity).

The results of this report will be used to: conduct problem-solving sessions with our employees; assist in development of the City's 5-year forecast and budget priorities.

Attachments:

- CalPERS Circular Letter dated April 26, 2013 titled "Employer Rate Increases Due to Amortization and Smoothing Policy Changes"
- GASB Statement

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CalPERS

Reference No.:
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Special:

Circular Letter

April 26, 2013

TO: **ALL PUBLIC AGENCY EMPLOYERS**

SUBJECT: **EMPLOYER RATE INCREASES DUE TO AMORTIZATION AND SMOOTHING POLICY CHANGES**

The purpose of this Circular Letter is to inform you of recent changes to the CalPERS amortization and smoothing policies. **These changes are expected to increase employer contribution rates in the near term but result in lower contribution rates in the long term.**

Background

At the April 17, 2013 meeting, the CalPERS Board of Administration approved a recommendation to change the CalPERS amortization and smoothing policies. 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. After this change, CalPERS will employ 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.

The new amortization and smoothing policy will be used for the first time in the June 30, 2013 actuarial valuations. These valuations will be performed in the fall of 2014 and will set employer contribution rates for the Fiscal Year 2015-16.

Analysis

The current amortization and smoothing policy was designed to reduce volatility in employer contribution rates. The policy has accomplished this goal fairly well since its adoption, however a number of concerns have developed:

- The use of an actuarial value of assets corridor can lead to significant single year increases to rates in years when there are large investment losses.
- The use of long asset smoothing periods and long rolling amortization periods result in slow progress toward full funding.
- The use of an actuarial value of assets requires the disclosure of two different funded statuses and unfunded liability numbers in actuarial valuation reports. This adds confusion and inhibits transparency.
- The use of rolling amortization and long asset smoothing periods makes it difficult for employers to predict when contribution rates will peak and how high that peak will be.

- The use of rolling amortization and asset smoothing periods may result in additional calculations for the new accounting standards. These calculations would be avoided with a quicker funded status recovery.

The adoption of the new smoothing and amortization policies will change future employer contribution rates. Changes are as follows:

- Funding levels will improve, which will reduce the funding level risk. The new methods will put your plan on a path to be fully funded in 30 years.
- Your plan will experience more rate volatility in normal years, but a much reduced chance of very large rate increases in years when there are large investment losses.
- Contribution rates in the near term will increase.
- Long term contribution rates will be lower.
- There will be greater transparency about the timing and impact of future employer contribution rate changes.
- The new policy eliminates the need for an actuarial value of assets. As a result, there will be only one funded status and unfunded liability in actuarial reports.
- There will be less confusion when the new accounting standards are implemented since there will be no need for extra liability calculations.

Expected Rate Increases Due to Changes
The following table can be used to gauge your agency's expected increase in employer contribution rates under the new amortization and smoothing policy.

The illustrated rates are based on public agency asset volatility ratios. The asset volatility ratio (AVR) is an agency's assets divided by their annual payroll. This ratio provides a measure of how sensitive an agency's contribution rate will be due to investment returns. For pooled plans, the AVR is the asset volatility ratio of the pool. Your plans AVR is provided in the risk analysis section of your annual actuarial report. The table shows the projected increases in employer contribution rates for Fiscal Years 2015-16 through 2019-20, assuming CalPERS earns 7.50 percent after 2011-12. Projections for Fiscal Year 2014-15 are not affected. As an extreme example, we have included a plan with an AVR of 15.

Cumulative Projected Increase in Employer Contribution Rate beyond the Projected Fiscal Year 2014-15 Rate

Fiscal Year	AVR of 4	AVR of 6	AVR of 8	AVR of 10	AVR of 15
2015 – 2016	1.1%	1.7%	2.2%	2.8%	4.2%
2016 – 2017	2.2%	3.4%	4.4%	5.6%	8.4%
2017 – 2018	3.3%	5.1%	6.6%	8.4%	12.6%
2018 – 2019	4.4%	6.8%	8.8%	11.2%	16.8%
2019 – 2020	5.5%	8.5%	11.0%	14.0%	21.0%

For example, suppose your agency has an estimated 2014-15 contribution rate of 14.5 percent and an AVR of 4. Referring to the table above, under the AVR of 4 column, you can expect to see a 1.1 percent increase in your current employer contribution rate for 2015-16 resulting in a 15.6 percent rate, a 2.2 percent increase for 2016-17 for a 16.7 percent rate, and so forth until the rate reaches an expected maximum of 20.0 percent in Fiscal Year 2019-20.

Be aware these are only estimates since we do not know the final return on investments beyond June 30, 2012. Your employer rate will also differ due to your own plans demographic experience, or if you are in a pool, due to the pool's demographic experience.

Overall, these contribution increases will result in your plan being better funded in time and will ultimately result in lower contribution rates.

If you have any questions, please call our CalPERS Customer Contact Center at **888 CalPERS** (or **888**-225-7377).

ALAN MILLIGAN
Chief Actuary

GASB STATEMENT NO. 68, *ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS*

On June 25, 2012, GASB approved Statement No. 68, *Accounting and Financial Reporting for Pensions – An Amendment of GASB Statement No. 27*. Statement No. 68, which primarily relates to reporting by governments that provide pensions to their employees, is effective for fiscal years beginning after June 15, 2014.

Key changes include:

- Separating how the accounting and financial reporting is determined from how pensions are funded.
- Employers with defined benefit pension plans will recognize a net pension liability, as defined by the standard, in their government-wide, proprietary and fiduciary fund financial statements.
- Incorporating ad hoc cost-of-living adjustments and other ad hoc postemployment benefit changes into projections of benefit payments, if an employer's past practice and future expectations of granting them indicate they are essentially automatic.
- Using a discount rate that applies (a) the expected long-term rate of return on pension plan investments for which plan assets are expected to be available to make projected benefit payments, and (b) the yield or index rate for 20-year, tax-exempt general obligation municipal bonds with and average rating of AA/Aa or higher to projected benefit payments for which plan assets are not expected to be available for long-term investment in a qualified trust.
- Adopting a single actuarial cost allocation method – entry age normal – rather than the current choice among six actuarial cost methods.
- Requiring more extensive note disclosures and required supplementary information (RSI).

As an employer, the City will be subject to the provisions of Statement No. 68 beginning with the fiscal year ending June 30, 2015. Statement No. 68 replaces the requirements of Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers* and Statement No. 50, *Pension Disclosures – An Amendment of GASB Statements No. 25 and No. 27*, as they relate to governments that provide pensions through pension plans administered as trusts or similar arrangements that meet certain criteria.

The Statement requires governments that participate in defined benefit pension plans to report in their statement of net position a net pension liability. The net pension liability is the difference between the total pension liability (the present value of projected benefit payments to employees based on their past service) and the assets (mostly investments reported at fair value) set aside in a trust and restricted to paying benefits to current employees, retirees, and their beneficiaries.

The Statement calls for immediate recognition of more pension expense than is currently required. This includes immediate recognition of annual service cost and interest on the pension liability and immediate recognition of the effect on the net pension liability of changes in benefit terms. Other components of pension expense will be recognized over a closed period that is determined by the average remaining service period of the plan members (both current and former employees, including retirees). These other components include the effects on the net pension liability of (a) changes in economic and demographic assumptions used to project benefits and (b) differences between those assumptions and actual experience. Lastly, the effects on the net pension liability of differences between expected and actual investment returns will be recognized in pension expense over a closed five-year period.

Statement No. 68 also requires employers to present more extensive note disclosures and RSI, including disclosing descriptive information about the types of benefits provided, how contributions to the pension plan are determined, and assumptions and methods used to calculate the pension liability.

These changes, however, relate only to accounting and financial reporting, not to how governments approach the funding of their pension plans. Pension funding is a policy decision made by government officials.