

City of Palos Verdes Estates Pension Funding Policy

PURPOSE

The purpose of this Pension Funding Policy (“Policy”) is to provide guidance on the development and adoption of a funding plan for the City of Palos Verdes Estates’ four CalPERS defined benefit pension plans (Classic Safety, Classic Miscellaneous, PEPRSA Safety, and PEPRSA Miscellaneous). This funding Policy supports the decision making process of the City Council and should be consistent with the overall purpose and goals of the City of Palos Verdes Estates’ pension plans, as well as the City’s overall responsibilities to its residents. As used in this Policy, “City” shall mean the City of Palos Verdes Estates and/or the City and its related entities, as the context may require.

The City recognizes that a fiscally prudent Policy should:

- Maintain the City’s sound financial position;
- Align with City’s long-term financial plan;
- Provide guidance in making annual budget decisions;
- Ensure the City has the flexibility to respond to changes in future service priorities, revenue levels, and operating expenditures;
- Ensure that all pension funding decisions are structured to protect both current and future taxpayers, ratepayers, and residents of the City; and
- Protect the City’s ability to provide employees with the pension benefits promised.

BACKGROUND

The primary goal of funding defined benefit pension plans is to ensure that sufficient assets will be accumulated to deliver promised benefits when they come due and to protect pension benefits in situations that involve employer insolvency or bankruptcy. The City’s pension funding philosophy is to fully fund its pension benefit obligations and establishing sound funding guidelines promotes pension benefit security. This policy will guide the City’s strategy to fund the CalPERS pension plans up to 90% of the total accrued liability and no less than 80%, whenever possible.

The City is committed to fiscal sustainability by employing long-term financial planning efforts, maintaining appropriate reserve levels, and employing prudent practices in governance, management, budget administration, and financial reporting. As part of this commitment, the City will prepare long-term financial forecasts which will be updated on an annual basis. This Policy is intended to make all relevant information readily available to decision-makers and the public to improve the quality of decisions, identify policy goals, and to demonstrate a commitment to long-term financial planning

The purpose of this funding policy is to establish a framework for funding the City’s defined benefit pension plans, considering factors that are relevant to the plans and the City. These factors include:

- The financial position of the City;
- Stability of the plan and / or the affordability of the annual contributions;
- A structurally balanced long-range forecast (five years minimum);
- Benefit security;
- The terms of the CalPERS contract for the City, along with any related collective bargaining agreements; and

- Minimum funding requirements under State law.

There are numerous advantages to developing a funding policy, including the following:

- Provides the framework to ensure the proper management of future liabilities and to minimize the effects on operations. The adoption of a funding policy will ensure a disciplined decision-making process, which will contribute to better predictability in funding.
- Having a written summary of the funding policy that is accessible to the employees and the Public will help improve the transparency of funding decisions and increase the understanding of pension funding issues.
- The exercise of developing this funding policy improves the identification, understanding, and management of the risk factors that affect the variability of funding requirements and the security of benefits to the employees and retirees.

The City has a current Unfunded Accrued Liability (UAL) of \$19,224,341 as of June 30, 2020, as provided in CalPERS Annual Valuation Reports dated July, 2021, calculated with a discount rate of 7.0%. A \$750,000 additional discretionary payment was made in fiscal year 2021/22. CalPERS reported 21.3% investment returns for Fiscal Year 2020-21 and reduced its discount rate to 6.8% as part of its [Funding Risk Mitigation Policy \(pdf\)](#). This discount rate reduction further reduced the funded percentage.

CalPERS portfolios repeatedly underperform when measured against expected returns. A higher level of risk, increasing volatility and a “much steeper decline in expected returns” are anticipated, according to CalPERS’ published Capital Market Assumption. This included four blended surveys taken from 2017-2021. Thus, the City shall utilize the current CalPERS 6.8% discount rate to evaluate and report its funded percentage and unfunded accrued liability. The City shall also evaluate and report the funded percentage and unfunded liability associated with a conceptual 6.2% CalPERS discount rate* to model impacts of potential future reductions in the CalPERS discount rate.

** The City’s 2019-20 Pension Ad Hoc Committee recommended the following formula to model potential reduction in the CalPERS discount rate: “The City’s pension liabilities would be valued using a discount rate set at a rate that is 2.5% above a three-year rolling average of the 30-year treasury constant maturity rates as of June 30 of the fiscal year for which the actuarial valuation report is being prepared.” The City’s 2022 FAC and City Council ad hoc is recommending use of the “20-Year Expectations” 6.2% discount rate from the July 12, 2021 CalPERS “Asset Liability Management: Capital Market Assumptions: Survey and Methodology” to model sensitivities associated with potential future CalPERS reductions to their discount rate.*

PREPAYMENT OPTIONS

At the beginning of each fiscal year, the City shall analyze the cost / benefits of prepaying amounts due CalPERS during that fiscal year. The City shall continue taking advantage of any prepayment discount that is afforded by CalPERS, resources permitting.

FUNDING LEVELS

The City will strive to maximize its pension funding levels through analysis of the most beneficial amortization schedule(s), the budget process, allocation of reserves, and / or cost containment measures. The total funding amount will be a combination of the amount on deposit with CalPERS, and any City funds that are committed to reducing pension liabilities. The City’s Pension Funding Policy is structured in two phases to initially address the “current” unfunded accrued liability (Phase 1) and, secondly, “new” unfunded accrued liability (Phase 2).

PHASE 1 - CURRENT UNFUNDED ACCRUED LIABILITY

In consideration of the City's goal to improve the funding of the CalPERS pension plans, the City Manager's proposed budget will include a minimum supplemental payment of \$250,000 annually toward the reduction of the unfunded pension liability. This practice will continue until such time that the funded status of the CalPERS pension plans is at least 90%. When authorized, this supplemental payment will be funded and submitted to CalPERS at the beginning of the budget year.

Additionally, the City will allocate General Fund surpluses toward the reduction of the unfunded accrued liability, in accordance with any City adopted General Fund Surplus Policy. General Fund surpluses will be determined based on the annual audited CAFR with a funding recommendation brought to Council within three council meetings of receiving the CAFR from the auditors. The audit/CAFR should be completed within 180 days of fiscal year end. A minimum of 30% of each year's annual General Fund surplus will be submitted to CalPERS as an Additional Discretionary Payment. Once the plans are funded 90% or more, the City will allocate a minimum of 10% of the General Fund Surplus to a General Fund Committed Pension Reserve (described below) to be used for pension costs as directed by City Council.

Payments will be applied to the most beneficial amortization schedule to provide maximum benefit to the City's funding status.

PHASE 2 – NEW UNFUNDED ACCRUED LIABILITY

[This section is under development and is intended to be finalized by March 31, 2023.]

OTHER

General Fund Committed Pension Reserve

The City may establish a Committed Pension Reserve to transfer funds to the reserve to ensure that these funds will only be used for pension related costs (e.g., Normal Costs, UAL payments). The committed reserve can be accessed to pay CalPERS at any time to reduce volatility and offset unexpected pension rate increases. The committed reserve would have funds deposited into it at the discretion of the City Council, based on recommendations made by the City's Finance Advisory Committee (FAC) and / or City staff during the annual budget adoption process. For the calculation of funding levels, monies put in this committed reserve will be treated the same as putting monies on deposit with CalPERS.

Additional Discretionary Payments

In lieu of making deposits to a Committed Pension Reserve, Additional Discretionary Payments ("ADP") may be deposited with CalPERS at any time. The ADP will be applied, first, to any negative bases during the same period and, secondly, against any prior year bases until the ADP is fully expended. The remaining outstanding liability will then be recalculated and a new payoff schedule and annual contribution will be determined.

Employee Contributions

The City is committed to providing the pension benefits promised to and earned by its

employees. To facilitate its ability to deliver on those promises, the City will work with staff to maximize allowable contributions to Normal Costs. The City will further seek partnership with employee bargaining groups for additional contributions if CalPERS decreases its discount rate, which reduces the valuation of the accrued pension benefits and results in the need for additional contributions to sufficiently fund the plans.

115 Trust

When the pension plan funding status reaches 90%, the FAC and / or City staff shall evaluate if establishment of a 115 Trust would be beneficial and make a recommendation to Council.

CONSIDERATION OF FUTURE PENSION BENEFITS

To the extent that the City continues to have UAL, it is fiscally responsible for the City to not offer any enhanced pension benefits to City employees or other post-employment benefits. This will allow the City to focus its financial resources on the current pension obligations due to CalPERS. Further, any new ongoing General Fund revenue sources (e.g., a new tax or fee that did not exist prior to adoption of this policy) shall not be allocated towards enhanced pension benefits.

CHANGES TO PENSION FUNDING POLICY

Any changes to the City's Pension Funding Policy shall require a super majority 4/5 vote of the City Council.

TRANSPARENCY AND REPORTING

The City's pension plans shall be transparent to plan members, annuitants, the City Council, and residents. To achieve this:

- The City's annual actuarial valuation will be presented to City Council within 30 days but no later than 60 days after its release from CalPERS.
- The City's Pension Funding Policy and Actuarial Valuation report shall be co-located on the City website.
- The City's annual contribution, usage, and balance of a Committed Pension Reserve shall be included in the City's year-end financial report to the City Council.
- The City's Unfunded Accrued Liability and Funded Percentage shall be included in the annual budget and co-located with or in close proximity to the General Fund Surplus projection, modeled using both the CalPERS current Discount Rate and a more realistic 20 year expected rate of 6.2%.
- At the conclusion of each calendar year, an individualized annual report shall be distributed to employees outlining the contributions to and growth of their pension benefit for that year, and over a period of three years.

SAMPLE PROJECTION SCENARIOS

The following assumptions were modeled within the City's GovInvest tool:

- A rate of return of 21.3% for FY'21 and an estimated 3.0% rate of return for FY'22
- Discount rate and rate of return both set to 6.8% and 6.2% beginning FY'23
- Payroll growth equaling 3.0%
- A \$750,000 prepayment which was made in FY'22
- A \$750,000 prepayment recommended in FY'23
- No future General Fund surpluses assumed or modeled
- Subsequent \$250,000 annual Additional Discretionary Payments beginning FY'23

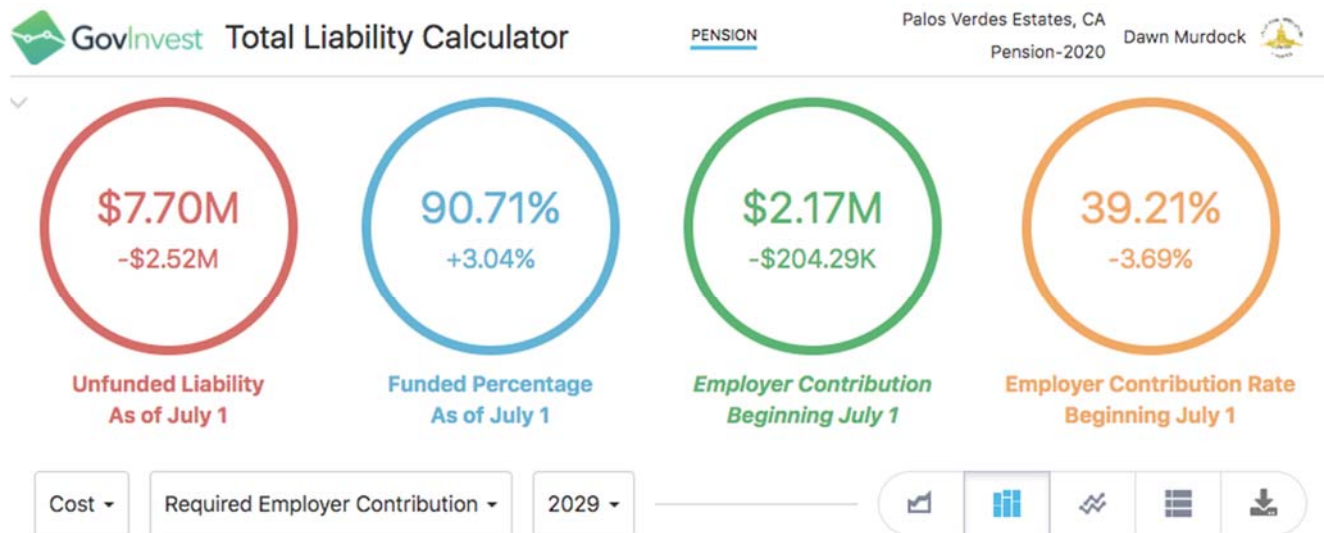
until 90% funded

- Additional Classic Safety Employee Pickup of 1% per year, as amended in recently memorialized Memorandum of Understanding with the Palos Verdes Police Officers Association
- Additional Classic Miscellaneous Employee Pickup of 1% beginning in FY'22, as amended in recently memorialized Memorandum of Understanding with the Palos Verdes Police Officers Association

A baseline or status quo scenario was set with the following assumptions:

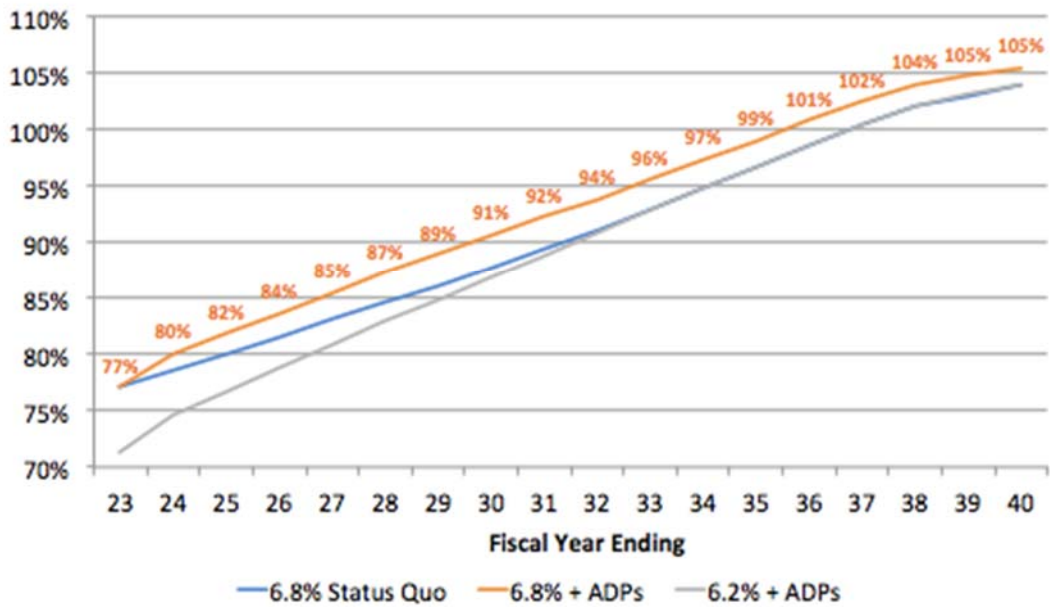
- A rate of return of 21.3% for FY'21 and an estimated 3.0% rate of return for FY'22
- Discount rate and rate of return both set to 6.8% beginning FY'23
- Payroll growth equaling 3.0%
- A \$750,000 prepayment which was made in FY'22
- Additional Classic Safety Employee Pickup of 1% per year, as amended in recently memorialized Memorandum of Understanding with the Palos Verdes Police Officers Association
- Additional Classic Miscellaneous Employee Pickup of 1% beginning in FY'22, as amended in recently memorialized Memorandum of Understanding with the Palos Verdes Police Officers Association

Modeling projected that by FY 29/30 the funded ratio would reach 90% and the UAL would be reduced to \$7.7M. Savings over a 20 year period are projected to be \$3.15M in employer contributions on a cash basis.



Total employer contributions from 2020 to 2039 decrease relative to your baseline by a total of \$3.15M on a cash basis.

Projected Funding Level



Projected Employer Contributions

