CITY OF CUPERTINO

ADMINISTRATIVE SERVICES DEPARTMENT

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AUDIT COMMITTEE STAFF REPORT

Meeting: October 27, 2020

Subject

OPEB & Pension Trust Investment Policy Review and Analysis

Recommended Action

Accept staff report and provide recommendations.

Discussion

Background

In FY 2009-10, the City established a Section 115 Trust to help fund its retiree health obligations, also known as other post-employment benefits (OPEB). In FY 2017-18, the City also established a Section 115 Trust to pre-fund its pension obligations and reduce the potential impact of pension cost volatility on the City's operating budget.

The Audit Committee is responsible for establishing, approving, and maintaining the investment policies for the Section 115 Trusts. On October 22, 2019, the Audit Committee reviewed the investment policies and adopted an OPEB Trust Investment Policy with a target rate of return of 6.5% and a Pension Trust Investment Policy with a target rate of return of 6.25%. The Investment Manager, US Bank, manages security selection and asset allocation in accordance with the investment policy.

Section 115 Trust Overview

A Section 115 Trust is a tax-exempt investment tool that allows local governments to pre-fund pension and retiree health costs. The benefits of a Section 115 Trust include the following:

- Local control over assets: The City controls the contributions, withdrawals, investment strategy, and risk level of assets in the Trust.
- Potential for higher investment returns than General Fund: Investment requirements that apply to the City's General Fund assets under Government Code 53601 are not applicable to Trust assets.

- Pension rate stabilization: Assets can be transferred to CalPERS at the City's discretion to pay for Normal Cost or UAL contributions, and can be used to reduce or eliminate large fluctuations in the City's pension costs.
- Diversification: Trust assets will be diversified from CalPERS investments.

OPEB Trust Overview

In FY 2009-10, the City established a Section 115 Trust to help fund its retiree health obligations, also known as other post-employment benefits (OPEB). Compared to a pay-as-you-go plan, the OPEB Trust allows the City to:

- grow assets to pay future OPEB benefits;
- earn higher returns than the General Fund;
- reduce its total cost for providing post-employment benefits; and
- reduce its net OPEB liability.

As of June 30, 2020, the City's OPEB Trust has a market value of $31.4 million and has earned an annualized investment return of 7.44% gross of fees since inception.

OPEB Trust Investment Objective

The OPEB Trust has a 'Balanced' investment objective with a target rate of return of 6.5%. The investment objective is designed to provide a moderate amount of current income with moderate growth of capital. This objective is recommended for investors with a long-term time horizon. The strategic asset allocation ranges and tactical targets for this objective are listed below:

Asset Class	Range	Target
Fixed Income	20-40%	29%
Equities	50-70%	63%
Real Estate	0-15%	5%
Commodities	0-10%	2%
Cash	0-10%	1%

CalPERS Overview

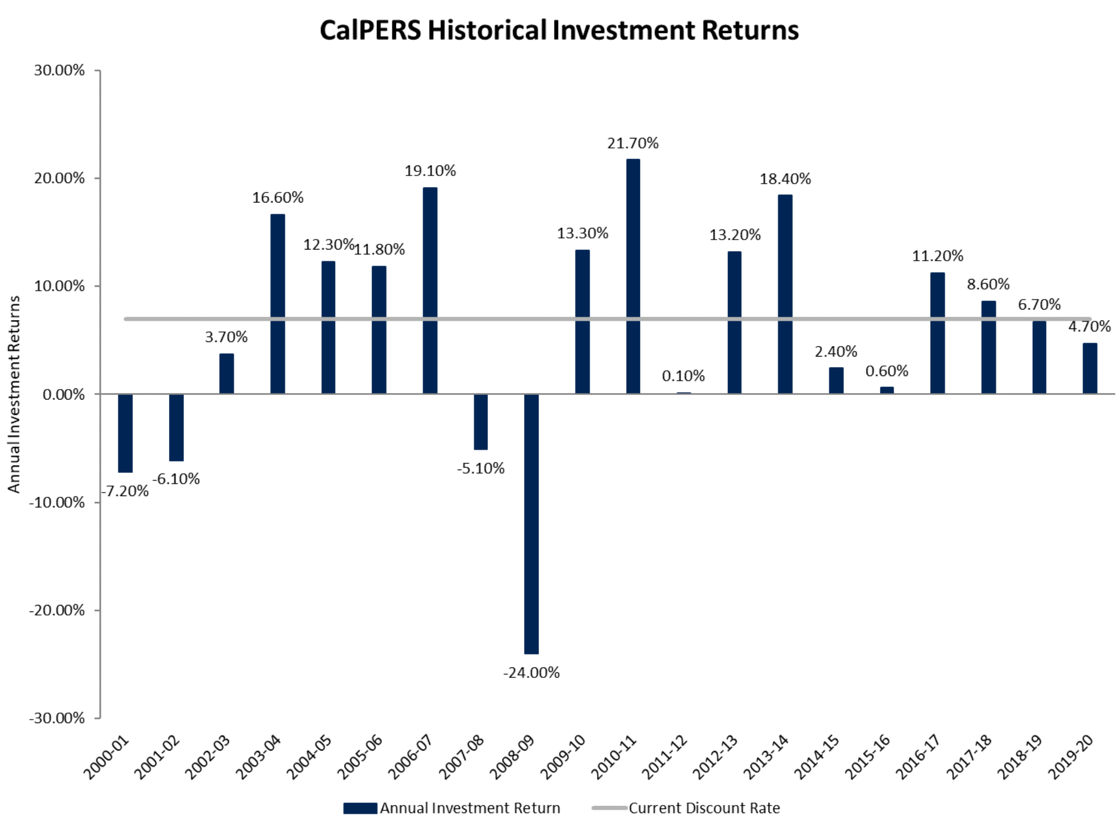
The City provides a defined benefit pension to its employees through the California Public Employees' Retirement System (CalPERS). Retiree pensions are calculated using a formula based on an employee's age, earnings, and years of service, and are funded by a combination of employer contributions, employee contributions, and investment earnings. Each year, CalPERS determines an employer's contributions based on actual investment returns and actuarial assumptions including:

- expected investment returns (discount rates),
- inflation rates,
- salaries,
- retirement ages, and
- life expectancies.

As of the June 30, 2019 actuarial valuation, the City's CalPERS plan has an actuarial liability of $148.5 million, an unfunded liability of $49.2 million, and a funded ratio of 66.9%. The unfunded liability is the difference between pension assets and liabilities while the funded ratio is the ratio of pension assets to liabilities.

A defined-benefit plan is considered adequately funded if its assets equal or exceed the value of its future liabilities. When the funded ratio is lower than 100%, the plan has insufficient assets to pay all future liabilities. Poor investment returns during the Great Recession significantly decreased the plan's assets. In addition, enhanced benefits and actuarial assumption changes due to increased life expectancies increased the plan's liabilities. These two factors significantly decreased the funded status of the system.

Over the past few years, CalPERS has taken steps to improve the long-term financial sustainability of the system. In December 2016, the CalPERS board voted to reduce the discount rate, also known as the assumed rate of return for investments, from 7.5% to 7.0% over three years from FY 2018-19 to FY 2020-21. In February 2018, the CalPERS board also voted to decrease the amortization period for new pension liabilities from 30 years to 20 years effective July 1, 2019. While these changes will provide long-term benefits to the pension plan, they will also increase the City's pension contributions.



For FY 2019-20, CalPERS reported a preliminary investment return of 4.7%, bringing the average investment return to 6.3% for a 5-year period, 8.5% for a 10-year period, 5.5% for a 20-year period, and 8.0% for a 30-year period. Given that returns in a given year are volatile, it can be more instructive to look at returns over longer time horizons.

Time Period	Total Investment Return
1 Year	4.7%
5 Year	6.3%
10 Year	8.5%
20 Year	5.5%
30 Year	8.0%

While the 10-year and 30-year investment return are above the 7% discount rate, the 5-year and 20-year investment return are below the 7% discount rate. If there are further reductions in the discount rate or if CalPERS investment returns continue to fall below the 7% assumption, the City's pension costs will increase further.

Pension Trust Overview

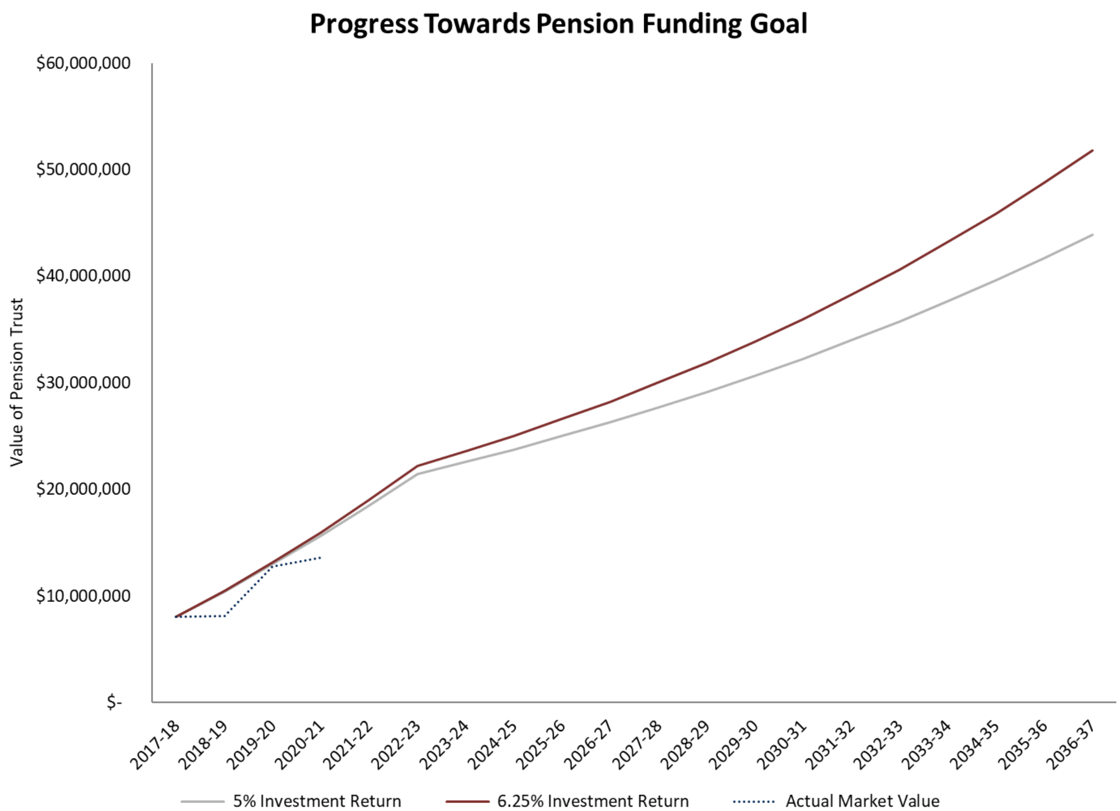
Given that pension obligations are one of the City's largest financial obligations, the City has taken proactive steps to reduce the impacts of pension cost volatility. In March 2018, the City provided options to Council on addressing rising pension costs. In April 2018, the City presented a long-term pension funding strategy to the Fiscal Strategic Plan Committee. In May 2018, the City implemented a Pension Rate Stabilization Program (PRSP), also known as a Section 115 Trust, to reduce the effect of pension rate volatility on the City's budget. The City contributed $8.0 million in FY 2018-19 and $4.0 million in FY 2019-20, bringing total contributions to $12.0 million. The Pension Trust helps the City to:

- grow assets for future pension contributions;
- invest assets over appropriate time horizons;
- earn higher investment returns than the General Fund;
- reduce pension contribution volatility; and
- diversify funds from CalPERS investments.

As a fiscal sustainability measure, the City funds the Pension Trust using a more conservative discount rate of 6.25%. The City's pension funding goal is to accumulate sufficient funds in the Pension Trust to fund the difference between a 6.25% and a 7% discount rate and achieve a funded ratio of 80% over 20 years. The City's projections indicated that the City would need to accumulate over $42 million in the Pension Trust within 20 years to achieve its pension funding goal.

To achieve this goal, the funding strategy proposed $8.0 million in initial funding, along with additional funding of $10.0 million over the first five years. The following chart illustrates the City's progress towards its pension funding goal. The 5% investment return represents the lowest investment return that would allow the City to achieve its goal. A

6.25% investment return is the current target rate of return of the Pension Trust. The dotted line represents the actual market value of the City's Pension Trust. The Pension Trust was funded with an initial contribution of $8.0 million and a subsequent contribution of $4.0 million in FY 2019-20. As of September 30, 2020, the City's Pension Trust has a market value of $13.6 million and has earned an annualized investment return of 6.70% gross of fees since inception. This chart illustrates that the City is on track towards its pension funding goal.



Note: The values are reported as of June 30 each fiscal year. The actual market value for FY 2020-21 is reported as of September 30, 2020. The 5% Investment Return and 6.25% Investment Return projections are for illustrative purposes only. Actual returns will be different.

Given this strategy and the City's current progress, the City is in a strong position to withstand the effects of pension cost increases. By using a more conservative discount rate than CalPERS, the City is able to allocate more towards pension funding each year than required by CalPERS. If CalPERS investment returns fall short of assumptions, the City will be better prepared for future pension cost increases. If the discount rate is lowered in the future, which is a distinct possibility, the City will be better prepared to absorb these costs.

Pension Trust Investment Objective

The Pension Trust has a 'Balanced' investment objective with a target rate of return of 6.25%. This investment objective is designed to provide a moderate amount of current income with moderate growth of capital. This objective is recommended for investors with a long-term time horizon. The strategic asset allocation ranges and tactical targets for this objective are listed below:

Asset Class	Range	Target
Fixed Income	20-40%	29%
Equities	50-70%	63%
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Discount Rate

Defined benefit plans are highly sensitive to the discount rate assumption. The discount rate is the expected rate of return of the plan's assets over the long term. The discount rate will depend on the plan's size, asset allocation, time horizon, and other considerations. The duration of the defined benefit obligation for a retiree health plan is often longer than that for a pension plan. As a result, the choice of discount rate for OPEB plans can be higher than it is for pension plans.

From the City's perspective, the discount rate is important as it is used to determine the City's annual contributions to the plan, the plan's unfunded liability, and the plan's funded status. In other words, the discount rate is used to determine whether a plan has enough assets to meet its future obligations. The discount rate must be realistic to allow the City to foresee funding issues that may impact future operating budgets and future generations of retirees and plan members. If the discount rate assumption is too high and investments earn less than expected, a funding shortfall may result, requiring the City or CalPERS members to make greater contributions than expected.

OPEB Discount Rate Analysis

The discount rate of the OPEB Trust is currently 6.5%. Under GASB 75, if an OPEB plan holds investments in a trust specifically to pay for future benefit payments and those assets are projected to be sufficient to make the projected benefit payments, the discount rate is based on the long-term expected rate of return for those investments.

The City's OPEB contributions are primarily driven by investment returns and changes in medical costs. A 1 percentage point decrease in the discount rate is expected to increase OPEB contributions by up to $565,000 per year.

CalPERS Discount Rate Analysis

While CalPERS currently uses a discount rate of 7%, market experts project lower returns for the next several decades due to lower-than-historical interest rates and economic growth. The Pew Research Center forecasts a long-term investment return of 6.4% while J.P. Morgan, and Wilshire Associates forecast a long-term investment return of 6.5% for typical pension fund portfolios.

The discount rate has a significant effect on the City's CalPERS contributions. If the discount rate is less than the 7% assumption, the City's CalPERS contributions will increase. If CalPERS lowers the discount rate by 1 percentage point, the City's contributions will increase by up to $2.4 million per year.

This analysis shows the potential contribution impacts if CalPERS were to lower the discount rate based on lower expected investment returns.

Recommendation
The City recommends maintaining the discount rates of 6.50% for the OPEB Trust and 6.25% for the Pension Trust. The discount rates are based on the long-term expected rate of return for assets in the trusts and the City's time horizon for the investments.

US Bank, the Investment Manager, and PARS, the Trust Administrator, have estimated a long-term expected return of 6.56% based on the current asset allocation (60%-80% equities).

The City recommends a higher discount rate for the OPEB Trust than the Pension Trust because OPEB investments are expected to have a longer time horizon. OPEB obligations are generally longer in duration and the City expects to withdraw Pension Trust funds earlier to fund CalPERS contributions. Given that changes to the CalPERS discount rate have larger effects on the City's operating budget and are farther out of the City's control, it is important that the City be able to use the trust to pay CalPERS contributions as needed. A lower discount rate can reduce investment return volatility and reduce the probability of losses to assets, allowing the City to better preserve its capital.

Sustainability Impact
There is no sustainability impact.

Fiscal Impact
There is no direct fiscal impact at this time. The discount rate assumptions will affect the City's contributions to the plan, the plan's assets, and the plan's liabilities.

Prepared by: Thomas Leung, Senior Management Analyst
Reviewed by: Kristina Alfaro, Administrative Services Director
Approved for Submission by: Deborah Feng, City Manager
Attachments:
C1 – OPEB Trust Investment Policy
C2 – Pension Trust Investment Policy