CITY OF SAN LEANDRO
Pension Funding Policy

PURPOSE

The purpose of this policy is to establish a risk-based capital (RBC) approach to managing the pension liabilities of the City of San Leandro, which participates in the California Public Employees' Retirement System (CalPERS). This policy aims to mitigate funding and investment risks associated with CalPERS' Public Employers Retirement Fund (PERF) by maintaining external capital reserves that help absorb market volatility and ensure the agency can meet its pension obligations while maintaining fiscal stability. The policy also includes specific actions to be taken when the combined funded status (CalPERS + external capital reserves) falls below or exceeds established thresholds.

By implementing this RBC-based pension funding policy, the agency aims to create a more resilient and risk-informed pension management framework consistent with the best practices of the Government Finance Officer's Association (GFOA). This approach ensures that the agency can meet its long-term pension obligations while maintaining financial stability in the face of market volatility and other external risks. The minimum, target, and maximum funding thresholds will serve as guideposts for ongoing fiscal management and long-term pension sustainability.

The policy focuses on building external capital reserves that act as a liquidity buffer, stabilizing the budget during times of market volatility and ensuring that UAL repayments are met without compromising essential services.

This Policy serves as a guiding document to:

1. **Articulate Pension Management Goals:** Clearly outline the City's objectives in managing pension funds, ensuring that they are well-defined and focused on the long-term sustainability of the pension system.

2. **Affirm Commitment to Pension Promises:** Emphasize the Council's unwavering commitment to fulfilling the pension benefits promised to employees, highlighting the importance of this responsibility in the City's financial planning.

3. **Demonstrate Fiscal Responsibility:** Show the Council's dedication to long-term fiscal discipline. This involves making prudent financial decisions that protect the interests of the City, its creditors, employees, and stakeholders, ensuring the financial health and credibility of the City.

4. **Set Reserve Targets and Augment Assets**: Establish clear reserve targets and implement strategies to enhance the pension fund's assets. This is crucial for mitigating the volatility risks associated with the pension fund's assets and liabilities.

5. **Outline Transparency and Governance Procedures:** Define and implement robust governance structures and transparency measures. This ensures that the pension management process is open, accountable, and subject to appropriate oversight.

6. **Support Informed Decision-Making:** Aid the City Council in making informed decisions by balancing the pension plan's funding objectives with the City's broader responsibilities to its citizens, including maintaining service quality and financial stability.

7. **Ensure Financial Stability and Flexibility:** Align the Policy with the City's long-term financial plan, ensuring that it contributes to maintaining the City's sound financial position. It should provide guidance for annual budget decisions and ensure the City retains the flexibility to adapt to changing service priorities, revenue levels, and operating costs.

8. **Safeguard Interests of Stakeholders:** Structure all pension funding decisions to protect the interests of current and future taxpayers, ratepayers, and residents of the City. This involves ensuring that the decisions made today do not unduly burden future generations.

9. **Guarantee Pension Benefits:** Protect the City's capability to provide its employees with the promised pension benefits, ensuring that the pension plan remains a reliable and stable source of post-retirement income for the City's workforce.

Through these guiding principles, the City San Leandro aims to manage its pension obligations responsibly and sustainably, ensuring fiscal health and stability while fulfilling its commitments to employees and stakeholders.

BACKGROUND

The City participates in CalPERS and relies on the Public Employers Retirement Fund (PERF), which assumes a long-term return with an annual volatility factor typically around +/- 12%. The volatility of the market can significantly impact the funded status of the agency's pension obligations, leading to fluctuating contribution requirements.

To address these risks, the agency will maintain **external capital reserves in a §115 trust,** held outside the pension fund to provide a financial buffer during periods of market downturns. These reserves will be used to support pension contributions when necessary and to stabilize the agency's overall pension funding strategy.

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. 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.

Developing a funding policy to address an unfunded accrued liability offers several benefits. Below are a few of the key advantages:

1. **Framework for Managing Future Liabilities**: Establishing a funding policy provides a structured approach to managing future liabilities. It helps in minimizing the impact on operational aspects of the organization. By adopting such a policy, there's a commitment to a disciplined decision-making process, which enhances predictability in funding requirements.

2. **Enhanced Transparency and Understanding**: Having a written summary of the funding policy, which is readily available to employees and the public, fosters transparency in funding decisions. This transparency is crucial for increasing the overall understanding of pension funding issues among all stakeholders.

3. **Improved Risk Management**: The process of developing a funding policy itself is beneficial as it aids in the identification, understanding, and management of risk factors. These factors can significantly affect the variability of funding requirements and the security of benefits for both current employees and retirees.

A well-defined funding policy not only ensures better management of liabilities but also promotes transparency and improves risk management, leading to more secure and predictable funding for pensions.

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. The City's pension funding goal is to fund its pension benefit obligations and establish sound funding guidelines that promote pension benefit security while preserving sufficient liquidity as not to negatively impact the City's ability to continue to provide services to the community. California Public Employer's Retirement Law (PERL) requires member agencies to contribute an Actuarial Determined Contribution (ADC) which is the City's ***minimum*** required employer contribution. The ADC is composed of the annual service cost of active employees (Normal Cost) plus an amount required to amortize any unfunded accrued liability (UAL Payment). If all other actuarial assumptions are met, making the UAL payment improves the funded status of the plan by approximately 1%-2% per year until the market value of assets with CalPERS reaches 100% of the funded status with CalPERS.

The City recognizes there are a significant number of assumptions that go into the development of the City's accrued pension liability and the annual volatility associated with the market value of assets that underpin the City's unfunded accrued liability and should not be disruptive for budgeting and planning purposes. This policy will guide the City's strategy to maintain a target minimum balance in the City §115 Pension Trust to minimize annual disruption and preserve flexibility. The policy also contemplates a maximum combined balance of assets with CalPERS and assets held in the City's §115 Pension Trust relative to the City's total accrued pension liability.

ONGOING COMMITMENT TO MANAGING PENIONS LIABILITY

Commitment to Funding the ADC: Unlike fixed-term debt, pension liabilities fluctuate over time due to changes in actuarial assumptions (e.g., mortality rates, retirement ages), investment returns, and economic conditions. Fixed-term debt has predictable payments and a defined payoff schedule, whereas pension liabilities are dynamic, with contributions recalculated regularly to reflect funding needs. This variability means that agencies cannot simply "pay off" unfunded liabilities in a predictable way, as the liability amount may increase or decrease based on future events and assumptions.

Committing to paying the full Actuarially Determined Contribution (ADC) each period is crucial for a pension plan sponsor for several reasons:

1. **Ensuring Financial Sustainability:** The ADC is calculated to ensure that the pension plan can meet its long-term obligations. By consistently funding the full ADC, the plan sponsor helps maintain the financial health and sustainability of the pension fund.

2. **Preventing Unfunded Liabilities:** Underfunding the ADC can lead to the growth of unfunded liabilities. Over time, these unfunded liabilities can become substantial, increasing the financial burden on the pension plan and potentially leading to a funding crisis.

3. **Stabilizing Contribution Rates:** Regularly funding the ADC helps to stabilize contribution rates over time. This consistency aids in budgeting and financial planning for both the plan sponsor and the beneficiaries.

4. **Maintaining Plan Solvency:** Paying the full ADC helps ensure that the plan remains solvent and can continue to pay out benefits as promised to current and future retirees. This is crucial for maintaining the trust and confidence of the plan members.

5. **Compliance with Actuarial Standards and Policies:** The ADC is determined based on actuarial standards and reflects the best estimate of what needs to be contributed to adequately fund the pension liabilities. Paying the full ADC demonstrates a commitment to these professional standards and sound financial practices.

6. **Avoiding Cost Shifting to Future Generations:** By fully funding the ADC, the plan sponsor avoids shifting the burden of current pension costs to future generations or future taxpayers. This is an important aspect of equitable and responsible fiscal management.

7. **Enhancing Credit Ratings and Investor Confidence:** Investors and credit rating agencies often view the full funding of pension obligations as a sign of financial health and responsible management. This can lead to better credit ratings and lower borrowing costs for the sponsoring government or organization.

8. **Risk Management:** Adequate funding reduces the risk associated with pension liabilities, such as investment risk, demographic risk, and inflation risk, by ensuring that funds are available to meet these challenges.

As a key component of prudent fiscal management for pension plan sponsors, ensuring the long-term viability of the pension plan and safeguarding the interests of both current and future retirees, the City is committed to paying the full ADC each year plus any additional amounts it deems appropriate and consistent with this funding policy.

MAINTAINING LIQUIDITY AND BUDGET FLEXIBILITY

Preservation of Financial and Budget Flexibility: The concept of "Preservation of Financial and Budget Flexibility" through maintaining adequate reserves is vital for the City, particularly in light of managing its accrued pension liabilities.

1. **Importance of Reserves for Financial Flexibility**: Reserves are crucial in providing financial flexibility. They function as a safeguard against unpredictability and economic fluctuations. This is particularly pertinent considering the substantial accrued pension liabilities and the volatility of the assets earmarked to fund these obligations.

2. **Preparing for Market Downturns and UAL Payment Increases**: In the event of a significant market downturn, the City faces the risk of being required by CalPERS (California Public Employees' Retirement System) to increase its Unfunded Accrued Liability (UAL) contributions to compensate for market-related shortfalls. This scenario necessitates prudent financial planning.

3. **Determining a Minimum Reserve Threshold**: To effectively address this risk, the City should consider maintaining a minimum reserve amount. A target balance of 3-8% of the City's accrued pension liability is suggested as a prudent benchmark. This reserve level is expected to be sufficient for managing unexpected hikes in UAL payments, thereby ensuring financial stability during turbulent times.

The establishment of a minimum reserve balance of 3% and a target reserve balance of 8% reflects a strategic approach to financial planning. It ensures that the City is equipped to handle unforeseen financial demands, particularly in relation to pension liabilities, while continuing to fulfill its service and infrastructure obligations to the community.

Maximum Reserves Available to Mitigate Pension Liabilities: The concept of "Maximum Reserves Available to Mitigate Pension Liabilities" reflects a prudent approach adopted by the City to balance its financial resources. This approach acknowledges the limited nature of available funds and emphasizes the importance of striking a balance between two key aspects:

1. **Funding Long-Term Obligations:** The City recognizes the significance of adequately funding its long-term obligations, such as pension liabilities. This involves setting aside sufficient reserves to ensure these obligations can be met over time. By doing so, the City aims to maintain financial stability and fulfill its commitments to current and future retirees.

2. **Meeting Current Service Needs:** At the same time, the City is aware of the immediate service needs of its current residents. This necessitates the allocation of resources to provide essential services and maintain the quality of life within the community. The City must ensure that while funding long-term obligations, it does not neglect the immediate and ongoing needs of its residents.

The concept of "Maximum Reserves Available" thus serves as a guiding principle for the City's financial planning. It requires careful consideration and management of available resources to simultaneously address long-term pension liabilities and current service requirements, acknowledging that resources are finite and must be judiciously allocated to meet both current and future needs while acknowledging short-term volatility risk associated with pension assets invested in financial markets.

<u>STRATEGIC INTEREST SAVINGS</u>

Opportunities to save Pension interest costs: "Saving Pension Interest Costs" involves strategic management of the City's payments towards CalPERS' Unfunded Accrued Liability (UAL) under the existing amortization policies.

1. **Challenges with CalPERS' UAL Amortization Policies**: CalPERS' UAL amortization policies, while designed to be accommodating for local agencies, especially those with limited budget flexibility, often result in extended and negatively amortizing payment schedules. This means that the debt may increase in the short term as interest accumulation outpaces the principal repayments.

2. **Default Payment Schedule as the Minimum Requirement**: The default payment schedule set by CalPERS represents the minimum amount that local agencies are required to pay. However, this minimum approach can lead to substantial interest costs over time due to the slow and negatively amortizing nature of the repayment structure.

3. **Accumulating Funds for UAL Repayment**: The City should consider accumulating available funds to address the inefficiencies of slow and negatively amortizing UAL repayment schedules. This involves

setting aside funds beyond the minimum required to maintain budget flexibility. Once this minimum threshold is secured, any excess funding and earnings can be allocated for strategic debt management.

4. **Role of the City Manager and Finance Director**: The excess funds and earnings should be made available to the City Manager, or as delegated, to the Finance Director. Their role would be to identify opportunities to reduce interest costs by making additional payments above the default schedule provided by CalPERS.
5. **Annual Review and Decision-Making Process**: Annually, the City Manager or Finance Director should evaluate and recommend strategies to the City Council during the Budget Process. This recommendation should focus on how best to utilize excess funds for reducing the long-term interest costs associated with the UAL repayment, thus ensuring more efficient and cost-effective debt management.

By strategically managing funds to make additional payments towards the UAL, the City can reduce the long-term interest costs associated with its pension obligations. This approach requires careful financial planning and regular review, with the goal of balancing fiscal responsibility and budget flexibility while minimizing overall interest expenses.

STRATEGY

The pension funding strategy centers on maintaining external reserves that provide a balance between protecting against investment losses and preserving financial flexibility. The strategy includes gradual reserve growth and cautious management of liquidity.

Key elements of the strategy include:

1. **Liquidity Focus**: Reserves are designed to stabilize the annual budget in times of volatility rather than fully cover the entire experience losses.
2. **Incremental Growth**: The reserve levels reflect a moderate approach to reserve building, with the possibility of increasing targets as the agency's financial condition improves.

RESERVE TARGETS

The reserve targets are defined as follows:

1. **Minimum Reserve**: **3% of accrued pension liability**. This minimum level allows for modest cushion for short-term needs. While intended as a minimum amount on reserve. However, this reserve level may be deployed to make minimum required employer contributions to CalPERS when a confluence of factors such experience losses and revenue shortfalls would otherwise strain operations.
2. **Target Reserve**: **8% of accrued liability**. This target offers a balanced level of protection while maintaining flexibility in budget management. Funds accumulated between the 3% and 12% target range may be deployed more strategically to reshape the UAL payment curve or otherwise pay down the UAL balance more efficiently to stop negative amortize amortization are derive additional interest savings.
3. **Maximum Reserve**: **12% of accrued liability**. The upper limit provides sufficient coverage to manage a significant experience loss. Once this level of external reserves is reached, funds could be used to pay the minimum required, employer contributions. Policy goals, adequacy of reserves and strategy should be periodically revisited for effectiveness. Any adjustments to the reserve levels should be made in accordance with the policy's RBC framework and risk tolerance.

4. Actions Based on CalPERS Funded Status

Funding at CalPERS should be between 70-90% of the accrued pension liability with a goal of 85%. Specific actions will be triggered based on the funded status at CalPERS:

1. **CalPERS Funded Status Falls Below 70%**: Consider supplementing the minimum required contributions to CalPERS by 1-2% of the accrued liability from annual budgetary surplus or from §115 trust reserves, provided the external reserve exceeds its minimum target balance of 3% of accrued liability.
2. **CalPERS Funded Status Falls Between 70-90%**: Consider use of reserves cautiously and strategically to supplement minimum contributions PERS where only where opportunities exist to achieve significant interest savings or to stop negative amortization.
3. **CalPERS Funded Status Reaches 90% or more**: Only make minimum contributions to CalPERS unless there is a compelling reason to do so. An example might be to offset a significant known loss not reflected in the latest valuation yet.

5. Reserve Replenishment Strategy

Replenishment of reserves may be structured based on payroll allocations and/or augmented by annual budget surplus. Guidelines may resemble the following or other plan replenishment plan approved by the City Manager.

1. **Mild Reserve Depletion**: **1-2% of payroll**. (Minimum reserve balance reached but less than target reserve balance of 8% of accrued liability).
2. **Moderate Depletion**: **2-4% of payroll**. (Minimum balance is greater than 50% but less than 100% of Minimum).
3. **Significant Depletion**: **4-6% of payroll** (Target minimum depleted below 50% of Target),

<u>GOVERNANCE PROCEDURES:</u>

The City will conduct an annual review of both the CalPERS-funded percentage and the external capital reserve levels. This review will ensure that reserves remain adequate and aligned with the agency's funding objectives and risk tolerance. This section outlines the governance protocols for ensuring responsible management, transparent communication, and strategic oversight of the pension funding policy.

Annual Communication and Reporting

1. **Annual Progress Reports:** Staff should annually communicate relevant known information necessary to assess progress towards pension funding objectives.

2. **Three-Year Historical Analysis:** Staff should include an aggregate summary of the plan's three-year historical funded status. This analysis helps in identifying trends, assessing the effectiveness of current strategies, changes in market conditions, and making informed adjustments.

3. **Projected Funded Status and Investment Returns:** After actual investment return experience is known, the City should project the funded status for the upcoming valuation year. This projection allows for potential changes in funded status and early identification of potential funding challenges.

4. **Stress Test Scenarios:** will be performed and presented to evaluate the potential impacts of various market conditions on pension funding and reserve adequacy.

5. **Long-term Forecast of UAAL Costs:** A minimum 7-10 year forecast of the Unfunded Actuarial Accrued Liability (UAAL) costs is highly recommended. This long-term forecast plays a crucial role in strategic planning and future budgeting.

Strategic Evaluation and Budget Recommendations

Annual Strategy Analysis: Each year, the City Manager or Finance Director is tasked with evaluating the pension fund's status and recommending strategies to the City Council during the Budget Process. These strategies should focus on efficiently allocating funds to preserve budget flexibility, reduce interest costs, reduce negative amortization associated with Unfunded Actuarial Liability (UAL) repayment and/or improve the funded status of the pension plan(s) as identified in the Funding Guidelines and Policy Parameters section of this policy.

1. **Review of Fiscal Year End Surplus/Deficit:** Upon the conclusion of the fiscal year or after the annual audit, City staff will assess all discretionary fund reserve balances. Depending on the circumstances, even shortly after the budget adoption, there may be a decision to utilize any available reserves or one-time savings from the previous fiscal year. These funds could be allocated to the §115 pension reserve, used for payments to CalPERS from the year-end surplus, or employed to address specific goals outlined in the strategic analysis.
2. **Budget Appropriation Recommendations:** In the annual budget, the City Manager and/or Finance Director are required to propose appropriations covering the Actuarially Determined Contribution (ADC) to the pension fund, along with any additional amounts specified in the "Funding Guidelines and Policy Parameters" section of this policy. This is crucial to ensure that pension funding is consistently and comprehensively integrated into the city's financial planning process.
3. **Handling Unforeseen Circumstances:** Occasionally, the City Manager may propose to the City Council the use of a portion of the pension reserve to meet the annual ADC, especially if maintaining the targeted minimum balance in the reserve could negatively impact community services. The policy stipulates that the reserve's target balance should be restored within a five-year timeframe. This provision allows for flexibility in financial management while ensuring long-term fiscal responsibility and sustainability of the pension reserve.

APPENDIX

ADC (Actuarially Determined Contribution): The ADC is the employer's annual required contribution to a pension plan, as calculated by actuaries. It typically includes two main components: the Normal Cost, which is the cost of pension benefits accruing in the current year, and an Amortization Payment towards the Unfunded Actuarial Accrued Liability (UAAL). The ADC is designed to cover the cost of benefits earned in the current year and to systematically eliminate any existing funding shortfall over an appropriate period. This contribution is crucial for maintaining the financial health and sustainability of the pension plan.

Normal Cost: is a key actuarial concept representing the cost of pension benefits accruing during a fiscal period, based on the present value of these future benefits. It's a crucial component in determining how much an employer and employees need to contribute to a pension plan each year together with assumed investment earnings to adequately fund the promised benefits.

UAL Payment: A payment made towards the Unfunded Actuarial Accrued Liability (UAAL) of a pension plan. It represents contributions specifically intended to address the deficit between the plan's current assets and the present value of its future pension obligations. This deficit arises due to various reasons, such as changes in actuarial assumptions, investment performance, or alterations in plan benefits. While Normal Cost looks forward, focusing on the current period's service, UAL payments address past service costs that have not been fully funded.

Prepayment of ADC: At the beginning of each fiscal year, the City considers the cost/benefits of prepaying ADP due to CalPERS during that fiscal year.

Additional Discretionary Payments (ADPs): ADPs may be deposited with CalPERS at any time. Within the constraints of this policy and appropriation by City Council, the City may make ADPs to CalPERS to achieve one or more of the objectives above, especially when components of the UAL (gain/loss bases) are negatively amortizing, or other opportunities exist that would likely result in an economic benefit to the City. Unless explicitly authorized by Council, ADPs to CalPERS should not be made if it can reasonably expect that assets with CalPERS would exceed 90% of the City's accrued liability.

Restructuring UAL Payment Schedule: The City may also consider full or partial restructuring of the UAL payment schedule (Fresh Start) to achieve one or more of the objectives above including preserving future financial flexibility or avoiding slow or negative amortization.

Pension Reserve: In a prudent effort to preserve financial liquidity and budget flexibility the City shall maintain a pension reserve within the constraints and limitations of this policy. The primary purpose of the reserve is to act as a "Pension Stabilization" fund acknowledging the CalPERS investment portfolio is volatile, the funded status can swing dramatically from one year to the next and may result in future budgetary challenges.

Before executing any of the pension payment strategies and tactics above, careful consideration should be made so that the resulting transaction should not adversely impact the liquidity, budget flexibility and general operations of the City,

Fixed (Closed) Amortization Periods: Consistent with GFOA recommendations CalPERS uses a closed amortization period based on fixed periods, meaning the timeframe over which the liability is to be paid off doesn't change with time. This contrasts with open amortization periods, which reset, potentially extending the payoff indefinitely.

Amortization Period Length: Consistent with GFOA recommendations the period should not exceed 25 years, with a preference for 15-20 years. This range is considered optimal for balancing the need to pay off liabilities in a reasonable timeframe without causing excessive short-term financial strain.

Layered Amortization Approach: Consistent with GFOA recommendations, CalPERS uses a layered amortization approach which involves separately tracking and amortizing different components of the unfunded liability as they arise. By treating each component (such as changes in actuarial assumptions, benefit changes, or investment gains/losses) separately, the plan can more accurately align costs with the causes of unfunded liabilities. This approach can lead to more transparent and manageable funding strategies.

"Ramping" vs "Non-Ramping" Amortization Bases: CalPERS amortizes different portions of the total unfunded liability two different direct smoothing technique, depending upon the type of event that created the particular portion of unfunded liability:

Investment Gains & Losses:
Investment Gains and Losses can, at times, be significant. To smooth gain and losses gradually into the aggregate UAL payment schedule, Investment Gains and losses are phased-in over a 5-year ramping period but are still fully amortized over a fixed 20-Yr period as follows:

- Year 1: 20% of base payment
- Year 2: 40% of base payment
- Year 3: 60% of base payment
- Year 4: 80% of base payment
- Years 5 through 20: base payment

Non-Investment Gains & Losses: With a few exceptions, all other gains and losses are amortized with a level-dollar payment without a ramp over the same fixed 20-year period.

Balancing Goals of Rapid UAL Amortization (Paydown):

Intergenerational Equity: This refers to equitably allocating the cost of pension liabilities among different generations. The idea is to ensure that each generation pays its fair share of the pension costs without unduly burdening future generations.

Volatility Management: This aims to maintain funding at a stable, predictable level, typically as a consistent percentage of payroll. This helps in budgeting and financial planning for the pension plan.