To: Board of Directors

From: Julio Morales, UPI

Date: May 25, 2022

Subject: Addressing CalPERS Unfunded Accrued Liability (UAL)

BACKGROUND

The Coastside Fire Protection District (District) provided a defined pension benefit to its employees through participation in the California Public Employees' Retirement System (CalPERS), prior to contracting with CAL FIRE. Employees participated in either a Safety Plan (firefighters) or Miscellaneous Plan (administrative staff).

- *Safety* employees participated in either 3.0%@50 or 3.0%@55 benefit formula. There are currently 58 retirees and 38 active members who transferred to another fire department and continue to contribute toward CalPERS.

- *Miscellaneous* employees receive pension benefits based on a 2.7%@55 formula. There are 4 retirees and 3 active members who transferred to another fire department and continue to contribute toward CalPERS.

Closed Plan

The District no longer has any employees, as such, the pension plan is considered a "Closed Plan" by CalPERS, which means that employees and retirees will not accumulate any pension benefits under the plan, however, there will be adjustments due to mortality and cost of living adjustments.

Unfunded Accrued Liability (UAL)

CalPERS actuaries have estimate that the total cost of the benefits earned by prior employees is equal to $42 million, while the market value of investments held and administered by CalPERS on behalf of the District is equal to $28.7 million, resulting in a funding shortfall, Unfunded Accrued Liability (UAL). Each year CalPERS actuary's review demographic and investment performance and makes adjustments to the unfunded pension liability. According to the most recent CalPERS actuarial report, June 30, 2020, the District has a UAL equal to $13.4 million, as illustrated in the table below.

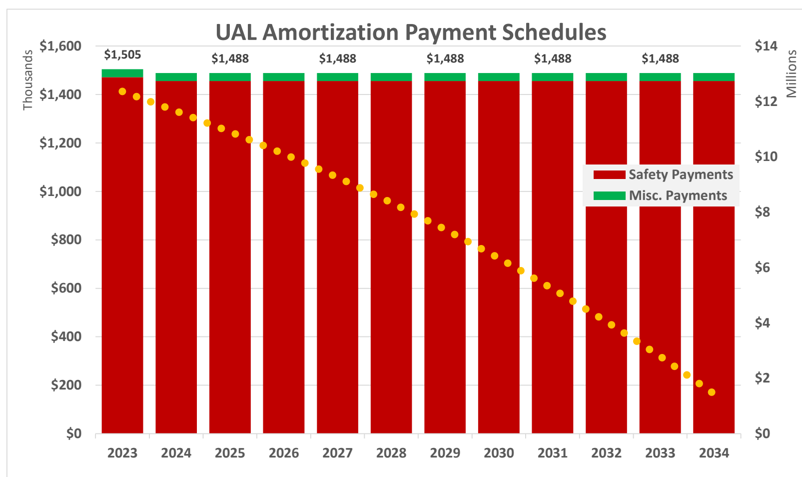
	Misc. Plan	Safety Plan	Combined
Accrued Liability (AL)	$ 714,666	$ 41,380,098	$ 42,094,764
Market Value Assets (MVA)	421,700	28,311,821	28,733,521
UAL = AL - MVA	**$ 292,966**	**$ 13,068,277**	**$ 13,361,243**
	59%	**68%**	**68%**

The District is responsible for making annual fixed dollar UAL payments equal $1.5 million: $32,806 for Miscellaneous Plan and $1,471,858 for Safety Plan.
Since the pension plan is closed, the District's UAL payments are structured as level dollar annual "Fresh Start" payments, which total $18 million over the next twelve years (2033).

Dynamic Liability

Actuarial calculations are based on a number of demographic and economic assumptions, which include life expectancy, ages at retirement, rate of retirements, disabilities, terminations and payroll inflation. Economic assumptions are based on salary growth rates, inflation rates, and the assumed rate of return known as the discount rate.

Although the District does not add any additional benefits each year, the District's pension liability is adjusted each year for a number of factors. Therefore, the District's UAL is not a static number. Each year CalPERS adjusts the UAL to account for investment performance, changes in assumptions, methodology, life expectancy, and change in benefit levels.



Therefore, the District should be aware of the UAL's dynamic nature and continually monitor its pension funding levels.

Projected FY21 Liability

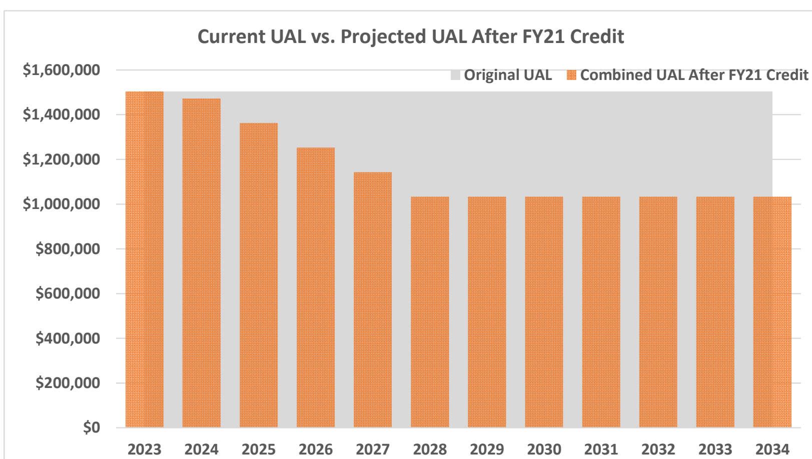
Last year, CalPERS reported a 21.3% investment return. This return will generate a significant "credit" toward the District current UAL. However, this significant excess return triggered an automatic reduction in the Discount Rate from 7.0% to 6.80%, in accordance with CalPERS' Funding Risk Mitigation Policy. CalPERS Asset Liability Management Committee also lower the Price Inflator assumption from 2.50% to 2.30%. Our model <u>estimates </u>the net result will be a net "credit" equal to UAL will be lowered by $3.6 million to approximately $8.75 million as of June 30, 2022

Note: CalPERS will provide the new actuarial report (dated June 30, 2021) in August of 2022 that will provide actual figures.

It is also important to note that CalPERS "credit" will not be applied until the *next* fiscal year. Therefore, the District will be required to make the currently scheduled UAL payment of $1.5 million. The projected UAL balance, next year (June 30, 2023), when the credit takes effect and taking this year's $1.5 million UAL payment is expected to be approximately $8.0 million.

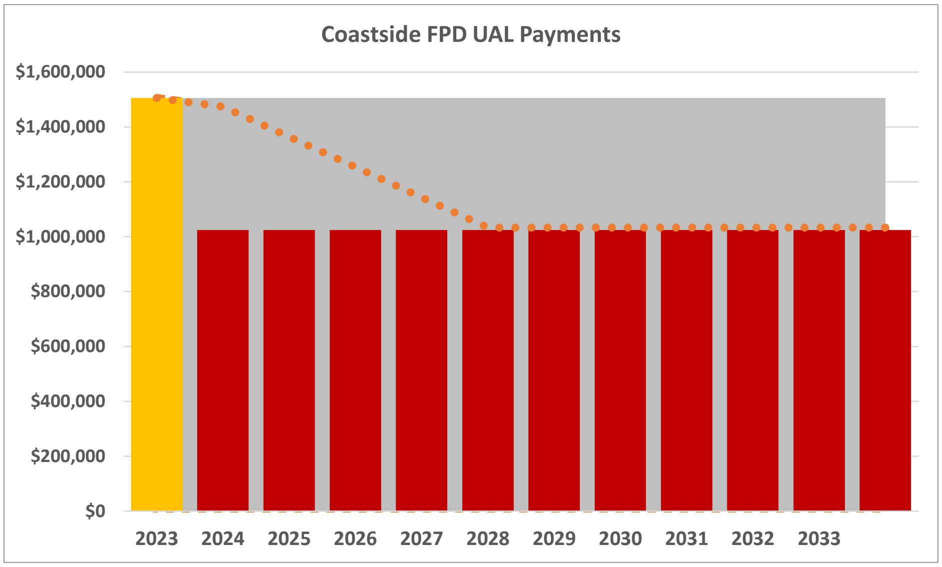
Projected UAL Balance: FY 23-24					
	UAL Balance June 30, 2023	FY21 Return 21.2%	Discount Rate & Price Inflator	Net Credit	UAL After FY21 Net Credit
Safety Plan	$ 11,416,744	$ (4,585,626)	$ 782,709	$ (3,606,991)	$ 7,809,753
Misc. Plan	254,469	(68,302)	18,953	(49,349)	205,119
	$ 11,671,213	$ (4,653,928)	$ 801,662	$ (3,656,341)	$ 8,014,872

CalPERS adjusts each members liability by adding new amortization bases, which typically have a 20-year payment schedule. Amortization bases related to investment return, have a 5-year ramp-up period then level annual payments. This creates a "shark fin" over the next few years, as illustrated in the chart below.



Fresh Start

The FY21 credit is expected to lower the District annual UAL payments. However, the current UAL payments go out to 2034, while the credit is applied over 20 years. There will be nine years (2035-2043), where CalPERS will have unused or "stranded" credits totaling $4.4 million. In order to capture both the stranded credits and eliminate the "shark fin" we would recommend that the District implement a Fresh Start to create level annual payments over the following 11 years (next fiscal year's $1.5 million UAL payment will not change). Implementing a Fresh Start is projected to save the District $1.2 million in UAL, as illustrated in the chart below.



For the sake of our analysis, we will assume that the District will implement a Fresh Start next fiscal year.

DISCUSSION

The District request its pension advisor, Urban Futures, Inc., to calculate the financial impact of making $1 million in additional payments toward paying down its UAL, and the impact of paying off its entire UAL.

Pay Off Full Liability - The District's UAL is equal to $12.3 million on June 30, 2022. The District is required to make a $1.5 million payment toward its UAL this upcoming fiscal year (FY22-23), and then is expected to receive a net credit for the FY21 return (21.3%) and lowering the Discount Rate (6.80%) the next fiscal year (FY 23-24) equal to approximately $3.6 million. As a result, the projected UAL will be $8.8 million as of June 30, 2022.

Paying off the full UAL next year would be expected to save a total of $14.0 million in UAL payment over the next 12 years (see table).

> *Miscellaneous UAL* – The estimated Miscellaneous Plan UAL will be $223,000. Paying off the UAL will save $285,000 in UAL total payments.
>
> *Safety UAL* – The estimated Safety Plan UAL will be $8.5 million. Paying off the UAL will save $9.4 million in UAL total payments.

If the District pays off the entire UAL, it may incur a new UAL balance due to the annual adjustments that CalPERS makes each year.

		Misc. Payments	Safety Payments FY 21 Credit	Combined UAL FY21
1	**2023**	32,806	1,471,858	1,504,664
2	**2024**	33,057	1,440,448	1,473,505
3	**2025**	31,440	1,331,946	1,363,386
4	**2026**	29,824	1,223,444	1,253,268
5	**2027**	28,208	1,114,942	1,143,150
6	**2028**	26,592	1,006,439	1,033,032
7	**2029**	26,592	1,006,439	1,033,032
8	**2030**	26,592	1,006,439	1,033,032
9	**2031**	26,592	1,006,439	1,033,032
10	**2032**	26,592	1,006,439	1,033,032
11	**2033**	26,592	1,006,439	1,033,032
12	**2034**	26,592	1,006,438	1,033,030
		$ 341,481	**$ 13,627,711**	**$ 13,969,192**
	UAL	**$ 223,329**	**$ 8,531,969**	**$ 8,755,298**

Adjusted Liability (New Base) – Each year CalPERS adjusts the UAL based on actual investment performance and demographic changes (i.e., life/death, COLA, retirement etc.). CalPERS current YTD return is approximately 2.0% through April 2022. This would result in a 4.8% loss (6.80% Target Rate – 2.0% Actual Return = 4.80% shortfall x $27.8 million = $1.3 million), which would increase in the UAL of approximately $1.3 million. So even if the District were to pay of its entire UAL this year, your UAL balance will fluctuate in the future.

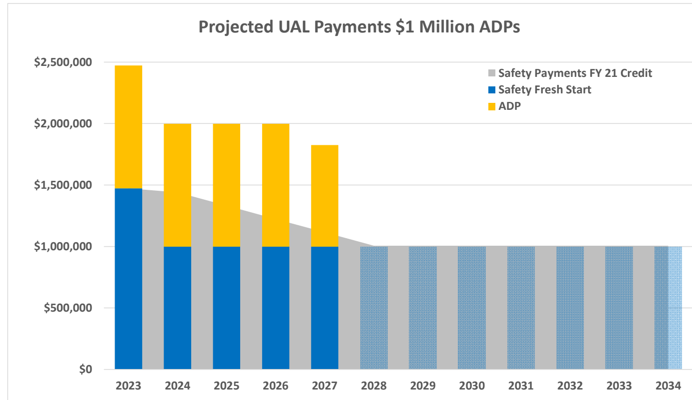
Onetime $1.0 Million Annual Discretionary Payment - The adjacent table illustrates the financial impact of making Additional Discretionary Payments or ADPs of $1.0 million from the District's reserves. A $1.0 million additional payment would lower the District's UAL by $120,000 per year, or $1,446,392 in additional UAL payments – resulting in 45% saving. Similarly, if CalPERS were to add $1.0 to the UAL, the District's UAL would increase by the same amount ($120,000 per year).

Balance	$1 Million ADP
1,000,000	120,533
943,437	120,533
883,027	120,533
818,509	120,533
749,605	120,533
676,014	120,533
597,420	120,533
513,481	120,533
423,834	120,533
328,092	120,533
225,839	120,533
116,632	120,533
	$1,446,392

Of course, the District would lose the investment earnings on its reserves. If you assume a 2.0% rate of investment, then the *net savings* would be $100,000 per annum or $240,000 over the next 12 years.

Annual $1.0 Million Annual Discretionary Payment

If the District were to make $1.0 million ADPs each year, in addition to the $1.0 million required UAL payments, the District would pay off its UAL in 5 years - save $3.3 million in Net UAL payments or $7.0 million after the UAL is paid off in 2027.



115 Trust / Pension Stabilization Reserve

Another option that was contemplated was establishing a 115 Trust and investing the monies in the trust as opposed to giving it to CalPERS. A 115 Trust is an irrevocable trust, designated by the IRS, which allows government agencies to segregate monies for specific purposes, often to address pension and OPEB costs.

There are two primary advantages of a 115 Trust: 1) monies can only be used for a specific purpose; 2) monies can be invested in equities and other investment vehicles that don fall within the California municipal investment guidelines.

Conceptually, investing monies in a 115 trust is a great diversification strategy. However, the CalPERS liability is only reduced when you make direct payments to CalPERS. The District could accumulate $10 million in assets in a 115 Trust, however, the CalPERS UAL will remain the same. The District will receive a credit on the balance sheet however.

Perhaps the most important factor to take into consideration is when using a 115 Trust (in lieu of making direct payments to CalPERS) the District assumes responsibility for investment returns (directly or indirectly).

Using a 115 Trust as a pension stabilization fund (savings or excess reserves set aside for unexpected or large increases in UAL) is commonly used by many agencies however. Primarily due to the fact that a 115 Trust can invest in equities and keep pace with CalPERS, while a regular reserve fund is invested in much lower yielding investments (e.g., LAIF).

FISCAL IMPACT

Making $1.0 million in additional payment to CalPERS will require an estimated $4.8 million, which would save the District $3.3 million over the next 12 years. The UAL savings after its paid off be would approximately $1.0 per year or $7.0 million in total, as illustrated in the chart below.

	Safety Payments FY 21 Credit	Safety Fresh Start	ADP	Fresh Start + $1 Million ADP	Savings
2023	1,471,858	1,471,858	1,000,000	2,471,858	**(1,000,000)**
2024	1,440,448	997,767	1,000,000	1,997,767	**(557,319)**
2025	1,331,946	997,767	1,000,000	1,997,767	**(665,822)**
2026	1,223,444	997,767	1,000,000	1,997,767	**(774,324)**
2027	1,114,942	997,767	827,446	1,825,213	**(710,272)**
2028	1,006,439	997,767			**1,006,439**
2029	1,006,439	997,767			**1,006,439**
2030	1,006,439	997,767			**1,006,439**
2031	1,006,439	997,767			**1,006,439**
2032	1,006,439	997,767			**1,006,439**
2033	1,006,439	997,767			**1,006,439**
2034	1,006,438	997,767			**1,006,438**
	$ 13,627,711	**$12,447,299**	**$ 4,827,446**	**$ 10,290,374**	**$ 3,337,337**
					$ 7,045,074

RECOMMENDATION

In the short term, Coastside Fire Protection District Board of Directors should strongly consider making their annual payment to CalPers in a one-time manner at the beginning of the fiscal year. This will reduce the interest the annual interest obligation. Additionally, the District should strongly consider implementing a "fresh start" that will reduce the Districts UAL liability.

Over the longer term, the Boards may be well served to consider one of the following strategies, based on available fund balances and reserves, to reduce the liabilities owed to CalPers:

1. Pay off full CalPers liability
2. Make an annual discretionary payment of $1 million
3. Establish a 115 Trust