ATTACHMENT I

DATE: April 5, 2016

TO: Mayor and Councilmembers

FROM: Director of Finance

SUBJECT: Annual City Benefit Liabilities and Funding Plan Review

RECOMMENDATION

That the Council reviews and comments on the status and funding of the City's benefit liabilities.

BACKGROUND

The City of Hayward, like all cities and municipal agencies, manages unfunded benefit liabilities as part of its financial picture. Effective 2013, staff began providing the Council Budget & Finance Committee (CBFC) and the City Council with an annual review of the City's benefit liabilities and funding plan. The CBFC reviewed a draft of this report at their March 2, 2016 regular meeting. During the FY 2016 budget process, both the Council and the CBFC spent considerable time developing funding policies related to the City's benefit liabilities, which were ultimately adopted by City Council. Attachment I-A is an excerpt from the City's adopted Financial Policies and represents only the section on Benefit Liabilities. The City's four benefit liabilities include:

1. California Public Employees' Retirement System (CalPERS)
2. Workers' Compensation (self-funded)
3. Other Post-Employment Benefits (OPEB) – Retiree Medical Benefits
4. Accrued Leave Payouts

Unfunded liabilities are defined as identifiable obligations of an organization for which the organization does not have 100% of the funding (cash or other assets) set aside to cover the cost should all obligations become immediately and simultaneously due. Generally, an a well-managed organization attempts to operate with a responsible balance between funding some identified portion of each of those obligations, the associated and manageable risk that the unfunded portion of the obligations presents to the organization, and responsible and realistic management of the organization's cash flow and other investments.

Achieving this careful balance is considered the practical and responsible approach since payment demands of these obligations rarely, if ever, occur simultaneously. The alternative would be to fund the obligations at the 100% level causing an unreasonable portion of the City's cash to be reserved and making it unavailable for funding on-going City services and operations.

DISCUSSION

The City actively manages its benefit liabilities and completes actuarial valuations for all benefit liabilities with the exception of accrued leave payouts (analysis conducted by staff). These valuations consider the economic, demographic, and historical compositions of the benefit programs and establish amounts that the City should set aside each year to fund its benefit-related financial obligations. In today's economic climate, it is critical that the City continue to manage its benefit liabilities to ensure long-term fiscal stability and the continuance of these valuable benefits to City employees. Actuarial valuations identify the Annual Required Contribution (ARC) an agency should make toward the funding of the benefit. This is essentially the minimum funding amount that should be responsibly made by any organization. The ARC is generally comprised of two elements: a portion of funding for current costs (sometimes referred to as "pay go"), and a portion of funding for future costs (the Unfunded Actuarial Liability or UAL).

As bond rating agencies review the City's debt, they actively consider the level of the City's unfunded benefit liabilities and the economic pressure this places on the City. Failure to meet the minimum recommended funding levels or implement a plan to achieve full funding of the ARC and/or a long-term plan to pay down the future liabilities could have a negative impact on future bond ratings – with a possible resultant increase in the cost of borrowing should the City seek to incur new debt.

Table 1 provides a summary of the City's benefit liabilities and current levels of funding based on the most recent actuarial valuations. Each of these benefit liabilities is unique in its structure and the degree of funding varies depending on the benefit. Acceptable or Best Practice levels of funding vary by liability type. In general, an appropriate range of funding would be 75 – 80 percent.

Table 1: Summary of Benefit Liabilities (in millions)

(in millions)	Actuarial Valuation Date	Accrued Liability	Value of Assets	Funded Ratio	Unfunded Liability (1)	Unfunded Ratio
CalPERS Police Safety Plan	6/30/2014	$ 320.42	$ 215.85	67.4%	$ 104.56	32.6%
CalPERS Fire Safety Plan	6/30/2014	$ 245.01	$ 174.18	71.1%	$ 70.83	28.9%
CalPERS Miscellaneous Plan	6/30/2014	$ 386.83	$ 280.14	72.4%	$ 106.69	27.6%
Total CalPERS		**$ 952.25**	**$ 670.17**	**70.4%**	**$ 282.08**	**29.6%**
OPEB - Retiree Medical Police Officers	6/30/2013	$ 43.37	$ -	0.0%	$ 43.37	100.0%
OPEB - Retiree Medical Firefighters	6/30/2013	$ 12.82	$ 0.76	6.0%	$ 12.06	94.0%
OPEB - Retiree Medical Miscellaneous	6/30/2013	$ 19.60	$ 0.08	0.4%	$ 19.53	99.6%
Total OPEB-Retiree Medical (1)		**$ 75.80**	**$ 0.84**	**1.1%**	**$ 74.96**	**98.9%**
Workers' Compensation	6/30/2015	$ 18.37	$ 9.65	52.5%	$ 8.72	47.5%
Accrued Leave Payouts (2)	6/30/2015	$ 7.10	$ -	0.0%	$ 7.10	100.0%
Total		**$ 1,053.52**	**$ 680.66**	**64.6%**	**$ 372.87**	**35.4%**

(1) Updated OPEB actuarial valuation in progress
(2) Accrued Leave Payouts - no actuarial valuation

California Public Employee Retirement System (CalPERS)

Current Annual cost: $28.3 million
Unfunded Liability: $282.1 million

Benefit Summary – CalPERS is a defined benefit pension plan funded by a combination of employee and employer contributions. A defined benefit pension plan is a type of pension plan in which an employer promises a specified monthly benefit on retirement that is predetermined by a formula based on such factors the employee's earnings history, tenure of service, and age. A defined benefit plan is "defined" in the sense that the benefit formula is defined and known in advance. A traditional pension plan that defines a benefit for an employee upon that employee's retirement is a defined benefit plan.

The City's retirement benefit plans represent its largest benefit liability and CalPERS retirement rates continue to be one of the most significant citywide budgetary pressures. This same budgetary stress is felt by the State of California and the over 2,000 public entities statewide that contract with the California Public Employees' Retirement System (CalPERS) for pension benefits. When CalPERS performs its actuarial analysis, it uses data from two years prior; for example, the employer rates for Fiscal Year 2017 are based on data as of June 30, 2014. The City contracts with an outside actuary (John Bartel & Associates) to review the City's rates each year, advise on the funded status of the plans, and project employer rates for future years.

The City contributes to three plans: Police Safety Plan, Fire Safety Plan, and Miscellaneous Employee Plan (all non-sworn employees). All full-time and part-time benefited employees are required to participate in CalPERS. The three plans are independent of one another with different contract plan amendments negotiated over the years through the collective bargaining process. Assets and liabilities of each plan are segregated with no cross subsidization from one plan to another.

CalPERS Retirement Rates – The cost of the retirement plan is broken into Employee Contribution rates (fixed) and Employer Contribution rates (variable). Both rates are a percent of payroll. The Employee Contribution is fixed and is based on the pension plan formula (generally 9% for public safety plans and 7% or 8$ for miscellaneous plans). The Public Employees' Pension Reform Act of 2013 (PEPRA) introduced new benefit formulas effective January 1, 2013 that affect new employees to the City that have not previously been part of the CalPERS system. While there is little immediate financial benefit to the City with this "two-tiered" system, the long-term benefit of lower retiree costs can be significant.

Most employee groups actually contribute beyond the Employee Contribution portion and pay a portion of the Employer Contribution: 6% for sworn police and fire personnel, 1% for all non-sworn personnel (with a phased-in increase to 3%). The Employer rates displayed in Table 1 represent the full Employer cost as assessed by CalPERS, and do not reflect these cost-sharing agreements, as these agreements do not affect the overall cost of CalPERS, only who pays what share.

Over the last several years, the CalPERS Board of Administration has considered and adopted several rate methodology changes that directly impact the retirement rates that cities pay (employer contribution rates). Each of these changes is effective in different fiscal years, with varying phase-in schedules. While these changes significantly increase our current retirement

costs, they are intended to stabilize the CalPERS plans for long-term sustainability, actually help the cities in the long-run, and should have been implemented long ago by CalPERS.

1. *March 2012 Change (effective FY 2014, two-year phase-in through FY 2015)*
   In March 2012, the CalPERS Board took action to reduce the assumed rate of investment return from 7.75% to 7.5%. The employer rate impact from this action was effective FY 2014, with a two-year phase-in; and a full rate impact by FY 2015. The actual rate impact resulting from this change was originally estimated to range from 2.4%–4.6% of payroll.

2. *April 2013 Change (effective FY 2016, five-year phase-in through FY 2020)*
   On April 17, 2013, the CalPERS Board adopted significant rate methodology changes that directly impacted employer rates starting in FY 2016 and are phased in over five years, with the full impact by FY 2020. The anticipated rate impact resulting from this change is approximately 2%–5% of payroll by FY 2020.These actuarial changes are designed to boost funding levels and make employer rates more predictable in the long-run:

   - ✓ Shorter smoothing period[1] and shorter amortization period for gains/losses
   - ✓ Closed instead of rolling thirty-year amortization
   - ✓ Use market value of assets to determine rates[2]

3. *February 2014 Change (effective FY 2017, five-year phase-in through FY 2021)*
   On February 18, 2014, the CalPERS Board adopted additional rate methodology changes. While the Board voted to retain its current long-term assumed rate of return at 7.5%, they did adopt actuarial changes to assumed mortality rates. The new mortality assumptions will cost local agencies an average of 6%–9% of payroll for safety classifications and 3%–5% of payroll for miscellaneous employees by year five of the phase-in (FY 2021). Some municipal officials believe these estimates may be low because of the continued decline in the local government workforce in many cities, reducing the number of active employees contributing to CalPERS.

4. *November 2015 Funding Risk Mitigation Policy*
   The CalPERS Board recently adopted a funding risk mitigation policy that will incrementally lower the discount rate in years of good investment returns, help pay down the pension fund's unfunded liability, and provide greater predictability and less volatility in contribution rates for employers. Under the policy, a mechanism will be established to reduce the discount rate

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[1] "Smoothing" and "Closed vs. Rolling Amortization" go hand in hand. Smoothing refers to the method by CalPERS plans to address the unpredictability of investment income and the impact that unpredictability has on employer rates. The revised "smoothing" plan determines the rate increase needed to reach a funding level of 100 percent in 30 years, phase in the rate increase over five years, and then to maintain those rates as steadily as possible or even lower them. In the past, CalPERS employed an amortization and smoothing policy that spread investment returns over a 15-year period with the actual gains and losses experienced by the investment pool paid for over a rolling 30-year period. With the current 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 a five-year period.

[2] CalPERS has traditionally used the actuarial value of their investments in their financial calculations and rate projections (i.e., the investment assets fluctuate in value from one day to the next, so the administrators calculate an average value for the assets, over a given period of time, or the "actuarial value"). In accordance with new FY 2015 GASB provisions, CalPERS will only use "market value," which is using the actual value of the investment assets as determined by the market and adjusting the value up or down accordingly.

- or assumed rate of return - by a minimum of 0.05 percentage points to a maximum of 0.25 percentage points in years when investment returns outperform the existing discount rate, currently 7.5%, by at least four percentage points. The four percentage point threshold would work to offset increases to employer contribution rates that would otherwise increase when the discount rate is lowered, and help pay down CalPERS' unfunded liability.

CalPERS staff modeling anticipates the policy will result in a lowering of the expected portfolio volatility to 8% in about twenty-one years, improve funding levels gradually over time, and cut risk in the System by lowering the volatility of investment returns. While rates are expected to increase for CalPERS employers in the future, the policy is designed to minimize any increases above projected rates.

The most recent actuarial valuations provided to the City of Hayward by CalPERS in November 2015 (actuarials dated October 2015) reflect the final rates for FY 2017 and incorporate all of the adopted changes to date, which result in FY 2017 rates increasing over FY 2016 rates by 1.9%–4.8% of payroll and growing each fiscal year through 2022 as currently projected by CalPERS. See estimated impacts to Hayward’s rates below in Table 2.

Purpose of Adopted Methodology Changes

While the revised methods are designed to create a sustainable CalPERS plan by improving funding levels and reducing the overall funding-level risk, the cumulative changes result in a significant increase in Hayward’s employer contribution rates through FY 2022; and in the very long-term (absent additional assumption changes), result in stabilized employer rates.

Estimated Rate Impacts

The new valuations the City received in November 2015 reflect rate projections that include all of the rate actions taken by the CalPERS Board to date. Table 2 provides a detailed summary of our revised CalPERS employer rates based on the October 2015 valuation. Per the CalPERS rate projections, by FY 2022, rates for Miscellaneous, Fire, and Police, are estimated to be 32.5%, 53.7%, and 59.7%, percent of payroll, respectively.

Table 2: CalPERS Rate Comparison & Growth

	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018	FY 2019	FY 2020	FY 2021	FY 2022
Miscellaneous									
CalPERS 10/2015 Valuation	19.70%	22.1%	24.47%	26.39%	28.10%	29.80%	31.40%	32.00%	32.50%
Change over prior year		**2.36%**	**2.41%**	**1.92%**	**1.71%**	**1.70%**	**1.60%**	**0.60%**	**0.50%**
Police									
CalPERS 10/2015 Valuation	35.19%	39.80%	42.40%	47.22%	50.08%	54.50%	58.10%	59.00%	59.70%
Change over prior year		**4.61%**	**2.60%**	**4.82%**	**2.86%**	**4.42%**	**3.60%**	**0.90%**	**0.70%**
Fire									
CalPERS 10/2015 Valuation	33.40%	37.15%	40.40%	43.12%	46.10%	49.10%	52.10%	52.80%	53.70%
Change over prior year		**3.75%**	**3.25%**	**2.73%**	**2.98%**	**3.00%**	**3.00%**	**0.70%**	**0.90%**

Table 2 provides a summary of rate increases since 2014. Rates for FY 2014 – FY 2017 are actual assessed rates, and FY 2018 – FY 2022 are estimates as provided by CalPERS. CalPERS rates are assessed as a percentage of payroll and the increases reflected in Table 2 demonstrate the percentage increase of payroll. Another way to summarize the increase in CalPERS rates is to look at the year-over- year percentage increase. Using the chart above, the average growth

increase in rates from FY 2015 to FY 2021 is about 65%. The trajectory of the rate increases reduces beginning in FY 2021. The estimated budget impact to the General Fund in FY 2017 is about $2 million over FY 2016.

Funding Status & Plan

The City is fully meeting its annual required contribution (ARC) amounts based on the CalPERS premium rates. Given the new CalPERS "smoothing" methodology, the long-term intent is to fund the City's liability over the 30-year amortization period. See Attachment I for further discussion regarding funding policies.

Retiree Medical (OPEB)

Annual Required Contribution (ARC): $7.7 million
Unfunded Liability: $75 million

Components of OPEB $7.7 million ARC:
$2.7 million: Current Retirees ("pay as you go") – FY 2016
$5.0 million: Unfunded Actuarial Liability – FY 2016

The retiree medical benefit represents the second largest benefit liability, and is the most significantly underfunded of the City's benefit liabilities. By City Council resolution – and as agreed to with some bargaining groups – the City provides certain health care benefits for employees who retire directly from the City with at least five years of City service (most bargaining groups require ten years of service) and who are vested in the California Public Employees Retirement System (CalPERS). The City participates in the CalPERS health care plan, which is governed under the California Public Employees Health and Medical Care Act (PEMCHA).

The City contributes a fixed dollar amount for retiree medical benefits for all employees, except sworn police employees hired before June 12, 2012 (rate tied to Kaiser plan rates), with amounts varying by employee bargaining group and coverage level as governed by PEMCHA. Benefits continue for surviving spouses in amounts as required by PEMCHA. As of June 30, 2015, approximately 602 retirees were eligible and were receiving retiree health care benefits from the City at an annual cost of about $2.7 million, which is the "pay as you go" amount the City currently pays.

There are approximately 687 active employees that may be eligible to receive health care benefits upon retirement. This group of employees represents the number of eligible, current employees and it is the City's current maximum exposure; it does not necessarily mean all of these employees will either retire with the City or ultimately meet the requirements for receiving this benefit. Similar to the CalPERS retirement plan, the increased life longevity of retirees places a stress on the benefit. The updated actuarial valuation of our local Plan will consider these impacts within its analysis.

Funding Status & Plan

The current annual required contribution (ARC) was determined as part of a May 1, 2014 actuarial valuation by Cheiron, the City's previous OPEB Actuary. This valuation analysis considered benefits that are expected to be earned in the future as well as those already accrued, and is required by the Governmental Accounting Standards Board (GASB) to be completed

every two years. An updated actuarial valuation is underway and should be completed within the next two months by Bickmore.

The City's OPEB unfunded actuarial accrued liability is amortized as a level percentage of projected payroll using a closed thirty-year amortization period that has twenty-four years remaining as of the latest valuation date. The minimum funding target is the Annual Required Contribution (ARC), currently estimated at $7.7 million and will likely increase with the new valuation. In the past, the City only funded the "pay as you go" portion of the plan. As of FY 2014, pursuant to City Council direction, the City began contributing toward the cost of the UAL both through direct City contributions, as well as employee contributions pursuant to some bargaining unit agreements. Payments for both components of the ARC are built into payroll to spread the cost appropriately across all City funding sources.

While the City is not fully funding the UAL, the City has made great progress toward this goal. The City's Ten-Year General Fund Plan includes phasing this cost in until the full ARC is achieved in FY 2022. Pursuant to the valuation, if the City fully funded the ARC, the City would pay for current costs and fund the future liability by the end of the amortization period. Because the City has not fully funded the ARC, the City will not meet this goal without additional funding allocations. See Attachment I-A for further discussion regarding funding policies.

Workers' Compensation

Current Annual Cost: $4.8 million
Unfunded Liability: $8.7 million

The City is self-funded for Workers' Compensation and began its program on July 1, 1975. While the City fully funds present day costs, it does not fully fund future liability. Payments are made to the Workers' Compensation Self-Insurance Fund by transfers from all City funds through established rates assessed against payroll pursuant to classification type. The amount of payments made by the City into the Workers' Compensation Self Insurance Fund is determined by an actuarial analysis conducted by an outside actuary (Bickmore). These accruals represent estimates of amounts to ultimately be paid for reported claims, past experience, recent claim settlement trends, and other information. Funds are available to pay claims and administrative costs of the program on a pay-as-you-go basis.

It is important to understand that payments on indemnity claims may be made over a very long period of years. Indemnity claims are those in which future medical care is projected to be needed for the injured worker and the cost is largely dependent on the type and severity of the injury, as well as whether or not the claimant is a sworn employee.

<u>*Funding Status & Plan*</u>

Pursuant to the current actuarial valuation conducted for the program, a funding status of 70%–85% is recommended. Table 1 shows that the City is currently at about a 56% funding level, which is an increase from previous years. Staff recommends funding at the 80% level and beginning in FY 2013, implemented a plan to build the fund balance toward achieving that funding level. Workers' Compensation rates charged against live payroll include a component of cost (about $1 million/year) toward unfunded liability. Once the 80% funding level is reached (about $10 million in fund balance reserved for future liability) – the Workers' Compensation rates will be adjusted downward. Staff recommends that the City continue with this plan until the funding goal is reached.

Accrued Leave Payouts (Compensated Absences)

Current Annual Cost: varies
Unfunded Liability: $7.1 million

It is the City's policy to permit employees to accumulate earned but unused vacation and sick leave benefits. The City records the cost of vacation and sick leave as "earned." Earned vacation and sick leave that is taken during the year is payable from the fund(s) to which the employee's salary or wage is charged. When an employee retires or otherwise leaves the City, vacation balances are paid out to the employee, and in some cases, some of the accumulated sick leave is also paid out (pursuant to bargaining unit agreements). These payouts are paid through a department's budget from vacancy salary savings – and are not specifically budgeted for as a separate line item.

Funding Status & Plan
Staff has taken strong action to lower this liability during the past three years by managing employees to approved vacation caps. This has helped to prevent large accrued leave payouts to retiring or terminating employees. The total liability has reduced from the FY 2012 balance of $10.7 million to the FY 2015 balance of $7.1 million – a 33.6% reduction in liability. However, while progress has been made in this area, it has been a challenge to get all employees below the cap due to staffing shortages compounded by increasing workload.

Table 3: Accrued Leave Liability History

	Unfunded Liability	Change from prior Year
FY 2007	7,003,161	
FY 2008	7,685,961	682,800
FY 2009	7,477,214	(208,747)
FY 2010	9,250,970	1,773,756
FY 2011	10,497,994	1,247,024
FY 2012	10,701,569	203,575
FY 2013	8,589,354	(2,112,215)
FY 2014	7,230,041	(1,359,313)
FY 2015	7,104,541	(125,500)

Accrued Leave payouts are currently absorbed within each department's budget appropriation. In practice, the salary savings achieved through normal attrition and the vacancy created by the exiting employee cover the cost of these payouts. In general, departments have had enough salary savings to accommodate this cost.

A possibility to further fund this liability is to build a funding mechanism into payroll as a component of the fringe benefit rate (e.g., 1% of payroll for non-sworn and 2% of payroll for sworn positions). This would result in a budgeted increase to the City budget without offsetting budgetary decreases – about $1.4 million to the General Fund. While this might provide a segregated funding source that would prevent spikes to department payroll budgets for large payouts, it does increase the overall City payroll budget. Given the City's fiscal challenges, it does not seem a prudent use of City resources at this time to add this cost. Staff recommends maintaining the current methodology of actively managing employee's leave balances to lower the overall liability. This has been successful these past several years as demonstrated in Table 3.

NEXT STEPS

Staff will continue to actively manage benefit liabilities and report annually to the Council Budget & Finance Committee and the City Council on the funding status of these benefit liabilities, including review of existing Council policies regarding funding.

Prepared and Recommended by: Tracy Vesely, Director of Finance

Approved by:

Fran David, City Manager

Attachment

Attachment I-A Adopted Benefit Liability Policies