TOWN OF LOS GATOS
TOWN COUNCIL FINANCE COMMITTEE
AGENDA

*Finance Committee – (2015)*

*Barbara Spector, Mayor*
*Steve Leonardis, Council Member*

TOWN COUNCIL CHAMBERS
110 East Main Street
December 21, 2015 – 10:15 a.m.

## MEETING CALLED TO ORDER

## ROLL CALL

## VERBAL COMMUNICATIONS *(Three minute time limit)*

## TOWN COUNCIL FINANCE COMMITTEE

1. Finance Department Responses to: "CALPERS' protracted plan for reducing investment risk leaves pension system vulnerable" by Daniel Borenstein.

2. Discuss Finance Committee 2016 Work Plan and Schedule

Attachments and Links

- Finance Department Response Memo
- D. Borenstein editorial: http://www.contracostatimes.com/daniel-borenstein/ci_28980965/daniel-borenstein-calpers-protracted-plan-reducing-investment-risk

## ADJOURNMENT

cc: Post *(also posted on Town Web)*
Town Council

**Finance Department Responses to: "CALPERS protracted plan for reducing investment risk leaves pension system vulnerable" by Daniel Borenstein.**

Published editorial in the print edition of the San Jose Mercury News on October 20, 2015

In a Mercury News editorial, columnist Daniel Borenstein stated concerns regarding the recent action taken by the CALPERS Board of Directors (Board). Specifically, Mr. Borenstein commented on the CALPERS Board election to take a potential lengthier "glide path" to lowering its internal discount rate. The discount rate is essentially CALPERS long term average return on investments. Lowering discount rates causes an increase in employer and employee rates, leading to more money coming into the pension plan, consequently reducing the effect of future large losses to the CALPERS investment portfolio which is the funding mechanism for retiree pension benefits. Mr. Borenstein's major concerns and staff's response are outlined below.

1. **Impact of Major Future Recession:** Currently, 60% of the CALPERS portfolio investments are in growth-type stocks. Growth stocks typically provide higher returns over the long term but with higher risk of losses during economic downturns. With 60% of investments being held in these stocks, Mr. Borenstein is concerned that if a major future recession occurs, losses sustained can only be recovered by "devastating" increases to state and local government CALPERS employer contribution rates. Such increases would impact the cost and by consequence the ability to provide services.

   **Staff Response:** The Board consciously chose a target of approximately 60% in growth funds, with the expectation that over the long term the yield will beat shorter term investments. As a point of comparison, the Board was informed that a survey of US state retirement plans indicated an average of 59.1% of their portfolios invested in growth or equity investments. There is risk in that target, but there is also substantial risk in reducing the portfolio to short term bonds yielding less than 1%. While these short term bonds are much more predictable, they would likely necessitate a huge increase to employer and employee pension contribution rates. Earnings from the CALPERS portfolio pay the highest share of pension benefits paid to retirees; hence a serious reduction in earnings would lead to a major increase in rates necessary to make the fund healthy.

2. **Portfolio Shift:** The Board rejected a plan to shift the portfolio from stocks to less risky investments like bonds. By doing so, Mr. Borenstein's concern is the CALPERS board is protracting the time span in which the investment portfolio is exposed to risk of market fluctuations.

**Staff Response:** Investing in lower yielding investments like bonds (current three year treasury yields are approaching less than 1%), would likely dramatically impact the contribution rates from both employers and employees. Most corporate and government plans invest a majority of their assets into longer term equity (stock) positons because over the long term the return is substantially higher than lesser yielding "safe" investments like U.S. Government Treasury Bills.

3. **Growth in Number of Benefit Recipients:** Mr. Borenstein stated that the PERS plan participants (those receiving benefit payments) are growing. In calendar year 2000 there were twice as many active CALPERS employees (those paying into the system) as there were CALPERS retirees receiving benefits. By 2025 CALPERS is forecasting that there will be more retirees receiving benefits than active CALPERS employees paying into the system. Mr. Borenstein is concerned with cash flows as more money will be paid out in benefits than is being paid into the system by active members.

   **Staff Response:** Staff was unable to confirm the demographic changes Mr. Borenstein refers to regarding the proportion of retirees drawing pensions to active employees paying into the system. However, the CALPERS annual report indicates a trend of approximately 9% annual increases to the number of employees adding to the retirement rolls. Assuming a trend of slow growth of new positions funded in recent years due to recession, it stands to reason that the ratio of retirees receiving benefits to active employees is growing.

4. **CALPERS Funding Level:** CALPERS funding levels, amount of money available to pay benefits, was once at 100%, or fully funded. In 2007, after the financial crisis, funding levels fell as low as 61% and are now 74% funded. Mr. Borenstein stated that CALPERS anticipates a 23 to 35% chance that funding levels may go below 50% over the next 30 years. Per Borenstein, funded levels below 50% would be considered a crisis point by PERS.

   **Staff Response:** Funding levels tend to fluctuate over time. As recently as the year 2000 many local government plans were fully funded. CALPERS indicated in its most recent report it expects to be currently 77% funded. The Board expressed a desire to achieve 100% funded position over time, looking at a 20-year time future time frame to move closer to that goal. To obtain 100% funding in shorter time period would require either an exceptional investment performance, and hence increased risk taking, or increases to either employer or employee contributions rates that would be unsustainable for many local government employees and employers. The National Association of State Retirement Administrators, the U.S. Government Accountability Office, and all major credit rating agencies agree that an 80% funded level for large pension plans is an acceptable level.

Finally, PERS staff indicates that the 77 % funding for the current CALPERS plan is expected to improve over time, but there is a 9 to 10% chance that funding levels may decline causing a deterioration of funding progress over time. Staff could find no discussion of a 50% funding level crisis scenario and as such cannot comment on Mr. Borenstein's comments regarding that issue.

5. **Discount Rate:** Lastly, Mr. Borenstein commented that the Board rejected lowering the discount rate, or rate of return, over a period of 20 years, to 6.5% from the current rate of 7.5%. Instead the Board adopted a method in which the discount rate will be lowered only during years of robust investment earnings.

**Staff Response:** In reviewing recent Board actions and materials presented regarding the CALPERS portfolio, the Board is in agreement that risk mitigation strategies be implemented. The Board had essentially two choices,

(1) Blended glide path: This plan is the more conservative approaching with checkpoints where the discount rates are lowered to ensure gradual reduction over time. Essentially, discount rates are lowered over a shorter time frame regardless of the positive or negative returns to the PERS portfolio; or

(2) Flexible glide path: This plan reduces discount rates only during years of excess investment earnings. This means that there is uncertainty as to when the discount rate will be lowered.

Staff could not corroborate that statement by CALPERS staff and/or any speaker at the August or September Board meeting indicating that rate increases contemplated under either plan would be of a "devastating" magnitude. However, in the August 15, 2015 meeting of the Board the recommendation was made to developing a risk mitigation strategy using the flexible method. This method would lower the discount rate during years when the investment returns exceed 4% above the actual discount rate.

A lowering of the discount rates will increase either employee or employer rates. It is estimated that for each ¼% lowering of the discount rate, either employee or employer rates will increase by an additional 1 to 2%. The new PEPRA law provides that if the discount rate is lowered, the employee contribution rate is required to increase to meet the "normal cost" of their pension. The CALPERS actuaries believe that lowering the discount rates will impact the normal cost calculations. These potential future cost increases for both employer and employee costs are likely to have an impact on future labor negotiations.

While lowering discount rates will increase employee and employer contribution rates, with the flexible glide method it is expected that the increases should be moderated by the additional value of the investments added to the portfolio due to the better than expected annual rate of return.

In publicly available documents, the Board has acknowledged the risk inherent in assuming that it can maintain its long term yield (discount rate) of approximately 7.5%. The Board approved staff to prepare a flexible plan to achieve a 6.5% discount rate target over the next 20 years. While the flexible plan has less certainty of achieving that goal, the Board has expressed interest in developing checks along the way to ensure that steps are being made to achieve the reduction to a 6.5% target.

**Conclusion:**

Staff agrees that the recent Board action was the less conservative choice which could potentially impact future rates negatively. However, future market returns over the long run cannot be accurately predicted. The CALPERS system is much like Social Security in that as more baby boomers move into retirement, the pension systems resources will be materially impacted. In 10 years there will be as many retirees receiving pensions as active employees paying into the system.

The Board is independent; its decisions are largely made based on a myriad of factors, including public comment, expert testimony, staff recommendations, and political pressure. Therefore, Town staff uses conservative measures when forecasting future rates and closely monitors the Board actions as they occur. The Town's Five Year Financial Plan also includes conservative assumptions about its future CALPERS rates based on continuing information received from the League of California Cities, the California Society of Municipal Finance Officers, the Town's actuaries, external auditors, and others including the external press. If material changes occur, the Town Council would be notified.