PENSION FUNDING POLICY

PURPOSE

The purpose of the Pension Funding Policy (the "Policy") for the City of Beaumont is to establish a comprehensive and prudent framework to manage the City's defined benefit pension obligations, in alignment with the best practices of the Government Finance Officer's Association (GFOA). 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 of Beaumont 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 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.

<u>FUNDING GUIDELINES AND POLICY PARMETERS</u>

Commitment to Funding the ADC: 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.

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. Here's a refined explanation:

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 3-5% of the City's budget 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 target minimum reserve balance of 3-5% 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.

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 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.

Plan Solvency: The concept of "Plan Solvency" for the City's pension plan involves a targeted approach to managing pension assets and liabilities, with the goal of maintaining a robust funded status.

1. **Target Funded Status of 110%:** The City aims to achieve a combined funded status of 110% of the accrued pension liability. This target ensures a buffer against the volatility of pension assets. The target funded status is comprised of the sum of funds held with CalPERS and any additional funds the City has reserved and specifically designated for pension liabilities (e.g. §115 pension trust).

2. **Response to Varying Levels of Funded Status**:

    - If funded status is below 110%: The City will aim to reserve or contribute to CalPERS an amount that is at least 0.25% of its accrued liability, in addition to the City's Actuarially Determined Contribution (ADC).

    - If funded status falls below 90%: The response remains the same as above, with an emphasis on reserving or contributing at least 0.5% of the accrued liability along with the ADC.

    - If funded status falls below 75%: The City will endeavor to set aside or contribute to CalPERS an amount greater than or equal to 0.75% of its accrued liability, in addition to the ADC.

Due to the volatility of pension assets, the City shall strive to achieve a combined funded status of 110% of the accrued liability. The total funding amount will be a combination of the amount on deposit with CalPERS, and any funds reserved by the City that are “designated” for pension liabilities.

ILLUSTRATION OF FUNDING GUIDELINES AND POLICY PARAMETERS

Recommended Funded Status Guidelines	Recommended Policy % (AL) Target Min.	Recommended Policy % (AL) Target Max	Recommended Targets based On Current (AL) $120M ($ For Illustration Purposes) Target Min.	Recommended Targets based On Current (AL) $120M ($ For Illustration Purposes) Target Max
Pension Reserve (115 Trust)	3%	20%	$ 3,600,000	$ 24,000,000
Assets with CalPERS	70%	90%	$ 84,000,000	$ 108,000,000
Combined Funded Status	**90%**	**110%**	$ 108,000,000	$ 132,000,000

Funding Guidelines*	Minimum Contribution Policy	Minimum Contribution Guidelines ($ For Illustration Purposes)
If greater than 90% funded status	ADC + .25% AL	$300,000
If Less than 90% but greater than 75%	ADC + .50% of AL	$600,000
If less than 75% but greater than 65%	ADC + .75% of AL	$900,000
If less than 65% of funded status	ADC + 1% of AL	$1,200,000

* Actuarial Determined Contribution (ADC) is the minimum required employer contribution. Additional contribution may be directed to increase to the City's 115 Pension Trust or to direct contribution to CalPERS provided the contribution would not foreseeably result in a funded status greater than 90% at CalPERS.

** Funds in excess of combined funded status guidelines shall be used to make the minimum required employer contributions (ADC).

GOVERNANCE PROCEDURES:

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:** Employers are required to annually communicate comprehensive information necessary to assess progress towards pension funding objectives.
2. **Three-Year Historical Analysis:** Employers 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. **Long-term Forecast of UAAL Costs:** A minimum 7-10 year forecast of the Unfunded Actuarial Accrued Liability (UAAL) costs is mandatory. 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 analyzes the cost/benefits of prepaying ADP due to CalPERS during that fiscal year. The City strives to continue taking advantage of any prepayment discount that is afforded by CalPERS.

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 three objectives above, especially when it is clear that 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 while maintaining the City's minimum general fund balance per the general fund policy.**

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.

Balancing Goals of Rapid UAL Amortization (Paydown):

- **Demographic Matching:** This refers to equitably allocating the cost of the 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.