

# *REPORT*

To the Honorable Mayor and City Council  
From the City Manager

May 8, 2006

## **Subject**

PERS 30-Year Rolling Amortization

## **Recommendation**

It is recommended that Council acknowledge receipt of a report from the Finance Director concerning changes that the California Public Employee Retirement System has made to how certain liabilities are amortized. No legislative action is recommended at this time.

## **Background**

As a member of the California Public Employee Retirement System (PERS), the City is required to make contributions to PERS on behalf of eligible employees to finance retirement benefits these employees are eligible to receive when they retire. This contribution is made every two weeks as part of the bi-weekly payroll process and whenever any other payments are made to employees that are considered PERS compensable wages. The City currently has two retirement plans with PERS: the Safety Plan which is comprised of all sworn police and fire department employees and the Miscellaneous Plan which is comprised of all non-sworn City employees.

Each year the actuarial staff at PERS provides the City with the actuarially required contributions for each PERS plan for the subsequent fiscal year. These rates are expressed as a percentage of PERS compensable wages and generally are comprised of two components: the normal cost and a "payment on the amortization bases." The payment on the amortization bases is the amount needed to pay off any unfunded liability. At times in which the City has a surplus rather than an unfunded liability the payment on the amortization bases is a credit which lowers the City's total required contribution.

In simple terms the normal cost is the amount the actuary determines is needed to pay the estimated retirement benefits prospectively. If all of the assumptions used in calculating the normal cost are achieved throughout the life of the retirement program, there would not be any unfunded liabilities or surpluses. In reality the actuary's projections are complex calculations based on many assumptions which are rarely met with complete accuracy. Also contract amendments can cause unfunded liabilities. As a result each retirement plan almost invariably has either an unfunded liability or a surplus.

Annually PERS prepares an actuarial valuation for each plan. The primary purpose of these actuarial valuations is to calculate the employer contribution rate for the subsequent year. Included in the actuarial valuation is a listing of each of the components of the employer's unfunded liability. There are different ways of amortizing these liabilities depending upon the nature or cause of the liability.

This past year PERS has changed how it amortizes several liabilities in a manner that has resulted in a significant decrease in the City's required contribution for FY2006/07 and, presumably, in years beyond. In the past all liabilities (except "gains/losses") were amortized over a fixed period of time with the eventual goal of extinguishing each liability at a fixed date in the future – in much the same way that a traditional residential mortgage is paid. Gains/losses were paid off at the rate of 10% per year.

The PERS Board of Directors approved several changes in the actuarial methodology used to calculate the FY2006/07 employer rates including using a "rolling 30-year amortization" to amortize certain liabilities resulting from "gains/losses" and "payment losses." The rolling 30-year amortization results in a lower contribution from the employer as no principal is scheduled to be paid each year - only interest. Not only does this arrangement result in the principal amount of the liability not being paid, but it results in negative amortization as the interest paid on this liability is 6% while the PERS interest assumption on investment returns is 7.75%. Accordingly the unfunded liability will grow at 1.75% annually if CalPERS interest and salary assumptions are realized and no changes are made.

Since the 1.75% negative amortization or growth in the unfunded liability is less than inflation and will likely be less than payroll growth, the unfunded liability as a percentage of payroll should decline although the real dollar value will be increasing.

In theory this liability will be reduced or eliminated should the investment returns realized by PERS exceed the 7.75% actuarially assumed rate of return. Given that this past year PERS has also changed their asset smoothing period from three years to fifteen years we believe it will take longer for employers to obtain the benefits of actual investment returns exceeding assumed investment returns because generally only 1/15<sup>th</sup> of such excess will initially be added to the actuarial value of the plan's assets.

The effect of this change is more pronounced on the City's safety plan due to the nature and source of the liabilities within this plan. The table below compares the employer contribution rates for both the safety and miscellaneous plans for FY 2005/06 and FY 2006/07:

**Employer Contributions - Percent of Payroll**

	Safety Plan		Miscellaneous Plan	
	2005/06	2006/07	2005/06	2006/07
Normal cost	17.5%	17.7%	7.5%	7.4%
Liability amortization	<u>19.1%</u>	<u>11.9%</u>	<u>3.7%</u>	<u>3.0%</u>
	36.6%	29.6%	11.2%	10.4%

The following table translates these contribution rates into dollar amounts and shows the savings the City should realize in FY2006/07 compared to FY2005/06:

**Employer Contributions - \$**

	Safety Plan		Increased Costs/(Savings)
	2005/06	2006/07	
Normal cost	\$2,997,806	\$3,144,471	146,665
Liability amortization	<u>3,281,475</u>	<u>2,110,229</u>	<u>(1,171,246)</u>
	\$6,279,281	\$5,254,700	(1,024,581)

	Miscellaneous Plan		Increased Costs/(Savings)
Normal cost	\$2,370,719	\$2,286,195	(84,524)
Liability amortization	<u>1,186,677</u>	<u>907,615</u>	<u>(279,062)</u>
	\$3,557,396	\$3,193,810	(363,586)

As can be seen by the preceding comparisons, as a result of this change the costs of the City's safety plan will decrease almost \$1 million while the costs of the City's miscellaneous plan will decline about \$400,000 for a total of \$1.4 million. This decrease in costs is one of the primary reasons staff has been able to recommend that the Council not make any reductions to the FY 2006/07 general fund budget. The trade-off to these savings is that the portion of the City's liability at PERS will be reduced, or paid off, over a less certain period of time or might not be paid off at all.

The City does have the option of sending funds to PERS at any time beyond the amounts PERS requires. Should the Council desire to do so, a decision must then be made as to the source of such funds, reserves, expenditure reductions, or from a new as of yet to be defined revenue source.




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