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CalPERS Board Approves Significant Lowering of Discount Rate

Increased Employer and Employee Contributions Coming

The CalPERS board of directors on Wednesday morning approved a plan to lower its discount rate (the expected rate of return on portfolio investments) from the current 7.5 percent to 7 percent over the next three years with corresponding incremental increases in employer/employee payments over an eight-year smoothing period. The action comes less than a day after the CalPERS Finance and Administration Committee approved the change and sent its recommendation to the full board. Negotiated between representatives from CalPERS, labor and Gov. Jerry Brown's Administration, the approved plan differs from the original CalPERS recommendation that would have lowered the discount rate immediately to 7 percent.

The League and the League Pension Task Force were well represented on Tuesday during the committee hearing with League staff testifying, as well as two city managers/fiscal officer(s) and one elected city official. The League and city officials communicated a clear message to the committee and CalPERS board members — lowering of the discount rate is a necessary step but it is by no means the solution to ensure the sustainability of the pension system. To do that, all stakeholders and the CalPERS board must rise to the challenge of difficult but necessary actions to ensure the viability of defined benefits for public employees.

Lowering the discount rate will mean higher contributions from city employers and employees. This is not easy for any CalPERS participating agency, however, stabilizing the fund ensures that the defined benefit promised to employees will be fulfilled. Standing League policy supports prudent policies to address the shortfall that recognize the impacts on local government. City officials are seeking a balance that brings stability to the pension fund while reducing spikes in employer contributions.

The plan provides three steps to incrementally move the discount rate from 7.5 to 7 percent. With each step, the impact of the rate change to unfunded liability payments will be phased-in over five years. This will process will occur over eight years. The steps are as follows:

- FY 2018-19: rate reduced from 7.5 percent to 7.375 percent;
- FY 2019-20: rate reduced from 7.375 percent to 7.25 percent; and
- FY 2020-21: rate reduced from 7.25 percent to 7 percent.

This action is being precipitated by investment returns that are well below the CalPERS assumed rate of return. The nation's largest pension fund reported just a 0.61 percent of return on investments for the fiscal year that ended on June 30, 2016, which is dramatically lower than the 7.5 percent assumed return. In addition, the overall CalPERS funded status has dropped from 73 percent funded to 68 percent in a short period of time. Absent any action, there is currently a 47 percent chance of the fund status dropping below 50 percent, which has been regarded as a point of no return since the grave negative cash flow will require assets to be liquidated and investments to stall.

League Cautions Optimism

The League has taken an active role in representing city governments in discussions with CalPERS and the Administration. The League reported on Dec. 9 that 240 cities had responded to the League's survey on proposed CalPERS discount rate changes.

Although, CalPERS has proactively reached out to local governments to solicit feedback on proposed changes, this proposal does not reflect a fully prudent plan for cities to meet their pension obligations. The plan does not account for two critical pieces of necessary reform. It lacks a mechanism to address employer/employee benefit structures. In addition, the extended phase-in period will result in local governments paying more to meet their pension obligations because of the accrued interest on their unfunded liabilities. However, the longer phase-in will be beneficial for cities facing budget challenges because the increased contributions will occur over a slower timeframe.

Next Steps

The League will continue to be an active voice in pension system changes. In the coming months, CalPERS will be reviewing their risk mitigation protocols and investment priorities and decisions. In addition, League staff will work with CalPERS to deliver all the necessary information cities will need to plan for the expected contribution increases.