City of Long Beach
Working Together to Serve

Memorandum

Date: September 5, 2009

To: Honorable Mayor and City Council

From: Laura L. Doud, City Auditor

Subject: CalPERS Prefunding Option for FY10

The issue of prefunding the City of Long Beach pension obligation for FY10 will come before you Tuesday, September 8 as part of the budget approval. "Prefunding" (paying the City's pension obligations at the beginning of the year instead of on a biweekly basis throughout the year) is intended to save the City money during the fiscal year and is a prudent decision for most years. This savings is predicated on the assumption that money invested earlier will accumulate more interest earnings, as it will be invested for a greater period of time. However, in the rare years in which there is a dramatic collapse of the stock market in the months immediately prior to prefunding (such as in 2008), current year savings are outweighed by additional losses to the City's pension assets caused by prefunding, based on an accounting rule used by CalPERS to allocate investment gains and losses.

Due to the stock market's precipitous collapse last summer, the City minimized losses to its pension assets by not prefunding for FY09. Specifically, we have calculated that by not prefunding, the City saved $3.48 million in pension assets. However, this was an anomalous year, and we agree with prefunding in a more typical year such as market analysts expect for FY10. Thus, barring some unanticipated catastrophic collapse in the CalPERS portfolio in the coming weeks, we support prefunding for FY10.

Attached is the "City Auditor's Analysis of FY09 CalPERS Funding Decision" for your review. Please do not hesitate to contact me if you have any questions or concerns.

Attachment

Cc: Patrick H. West, City Manager
Suzanne Frick, Assistant City Manager
Lori Ann Farrell, Director of Financial Management
Robert Shannon, City Attorney

City Auditor’s Analysis of FY09 CalPERS Funding Decision

Description of the Decision

Every year the City pays into CalPERS to fund pensions for City employees. One part of the contribution is called the “employer” contribution, and the amount of this contribution varies every year as determined by CalPERS actuaries. Many factors, including market performance, affect this contribution, which is based on a percentage of payroll for covered employees.

CalPERS allows participating agencies to fund their employer contributions in one of two ways: throughout the year, as periodic payments matching the City’s biweekly payroll periods (“pay as you go”); or by making a lump sum payment for the City’s fiscal year early in October (“prefunding”).

The decision facing the City in October 2008 for FY09 was: should we continue to pay the employer contribution throughout the year to CalPERS, as we have historically done, or should we make a lump sum payment?

Role of the City Auditor’s Office

Under Charter Section 804, the City Auditor reviews all City payments, including wire transfers. In accordance with this responsibility, our Office inquired as to these pension payments. We asked what accounting rule CalPERS would use to allocate our investment gains or losses, knowing that this information had been made critical by recent dramatic stock losses. When the relevant accounting rule confirmed our concerns, the Office advised against the prefunding plan, and management agreed to continue making pension payments in FY09 on a pay as you go basis.

Typical Considerations for Prefunding Decision

All City money invested in CalPERS, including those funds already invested and those funds invested during the current fiscal year, gain or lose value according to the overall performance of CalPERS. While CalPERS assumes a 7.75% investment return for actuarial purposes, actual performance can vary widely from year to year.

By prefunding, an agency is making its contribution ahead of time instead of in biweekly installments throughout the year. Thus, its funds are invested in the CalPERS portfolio for a longer period of time. Because CalPERS assumes an annual investment return of 7.75% on average, it reduces the amount of the City’s annual contribution if prefunded to reflect its assumption that this contribution will grow more by being invested for a longer period of time. For example, for FY09 CalPERS stated that the annual contribution for miscellaneous employees would be $26,038.979 if made throughout the year, or $25,085,070 if prefunded at the beginning of the year.

Long Beach is Not a Typical City, and FY09 is Not a Typical Year

Virtually all jurisdictions in the CalPERS plan share the same fiscal year as CalPERS (July—June), and they are requested to make this decision at the beginning of their fiscal year, in July. However, Long Beach is one of only a few cities to have a different fiscal year (October—September). For Long Beach, we are asked to make our prefunding decision at the beginning of our year, in October, which is already several months into the fiscal year for CalPERS.

Additionally, July 2008—June 2009 was one of the worst years for the stock market (and the worst ever for CalPERS's portfolio) since the Great Depression. CalPERS recently announced that its preliminary assessment of the portfolio's performance was that it had lost $56.2 billion for its 08-09 fiscal year, which it calculated as a 23.4% decline in the market value of its assets.

Discovery of Key Accounting Rule

All participating agencies, including Long Beach, share in the investment gains or losses of CalPERS. CalPERS measures the investment return percentage based on its overall performance in its fiscal year (July—June), and credits different agencies accordingly. Therefore, **even though Long Beach's fiscal year does not start until October, we are credited with the investment return percentage for the entire portfolio for the fiscal year starting in July**. However, **we are only credited for the time our money is actually in the CalPERS portfolio**.

Normally, a key rule of stock market investing is that you cannot know how your money will perform prior to investing. However, because of Long Beach's later fiscal year, the City effectively shares the return from July 2008 to July 2009 for funds contributed in October 2008—*after the start of the CalPERS investment period*. Prior to making the decision, CalPERS informed the City that its portfolio was down 20% for the period from July 1 to October 15, 2009.

Because Long Beach is a part of the CalPERS pension fund, we must make contributions to it, and we share in the gains and losses of the CalPERS fund overall. However, prefunding increases the City's exposure to CalPERS investments by allowing CalPERS to invest our money for a longer period, and thus prefunding is imprudent during years in which the fund is projected to have a negative return.

Thus, in rare cases in which it appears likely that CalPERS' portfolio will deliver a significantly negative return, the City should avoid prefunding. While the ultimate performance of the CalPERS portfolio cannot be known until after the end of the fiscal year, by October one quarter of the state's fiscal year is over and thus one can reasonably predict that a market that is down dramatically by that point is unlikely to recover sufficiently to provide a positive annual return.

Outcome

By choosing not to prefund, Long Beach saved an estimated $3.48 million in pension fund assets. While prefunding would have been a bad decision for FY09, it is important to note that prefunding is a good idea for a more typical year such as FY10. While Long Beach's overall pension fund has fallen due to the enormous losses suffered by CalPERS, we have limited that decline due to wise decisions by the City not to prefund for FY09.