Fire and Police Retirement System
Task Force Report

Presented to City Manager, Michael J. Beck

April 2010

Executive Summary

Upon the expiration of SB481, in 2014, the City of Pasadena will be facing a significant fiscal challenge as it relates to funding the City's obligation to the Fire and Police Retirement System. To give an idea of the scope of this challenge after the flow of Downtown Redevelopment funds ends, the City will be obligated to pay off, or refinance, approximately $81 million in Pension Obligation Bonds (POBs) after May 2015. Additionally, the City will be required to make supplemental contributions of approximately $120 million over 50 years to FPRS, with about $75 million of this occurring between 2016 and 2022. If the POBs are refinanced, and investment returns on the FPRS portfolio are as predicted, the total cumulative impact on the General Fund is estimated to exceed $215 million between now and 2074. Should investment returns prove less than projected, this problem will only be worse.

Immediate action is required now if the City has any hopes of mitigating the impact on the General Fund. The FPRS Task Force is recommending that the following steps, which are discussed at greater length in the body of this report, be taken:

1. **Establish a much closer working relationship with the FPRS Board.**

2. **Utilize existing SB481 reserve funds to increase plan assets and reduce volatility of the System's investment portfolio.**

3. **Amend the Contribution Agreement to decouple from the '37 Act Counties and allow for periodic mutually agreed upon changes in targeted investment return and inflation factors.**

4. **Reconsider investment strategy.**

5. **Consolidate administrative functions of the System within the City's Finance Department.**

6. **Request that the System undertake a new selection process for financial advisor and that this process be repeated at least every three to five years.**

7. **Consider buy-outs.**

8. **Pursue new revenue sources to provide for the System while shielding the General Fund.**

Introduction

At the request of the City Manager, the Fire & Police Retirement System (FPRS) Task Force was established in spring 2009. The purpose of the Task Force is to determine how the City may meet its obligations to System participants, particularly after December 31, 2014 when Senate Bill 481 expires and the flow of funds from the City's Downtown Redevelopment Project Area to support the FPRS ends, shield the general fund from risk, protect the taxpayers from the impacts of System obligations, and ensure the System is maximizing its assets.

The Task Force consisted of the following individuals:

- Margaret McAustin, member of the City Council
- Sid Tyler, former Councilmember and City representative on the FPRS Board
- David Goodrich, Vice President of Human Resources for Parsons Corporation and member of the City's Deferred Compensation Oversight Committee.
- Jaynie Miller Studenmund, whose broad experience includes financial services, as well as serving as CEO, COO and board member for a number of private and public companies including several prominent internet-based firms.
- Dennis Murphy, Principal in an accounting and management consulting firm providing tax, auditing, strategic planning, forensic analysis, business management, financial planning, and litigation support services. Mr. Murphy is an appointed Federal Receiver, as well as an appointed Chapter 11 Trustee and currently serves on the Rose Bowl Operating Company.
- Steve Mermell, Assistant City Manager
- Richard Bruckner, Director of Planning & Development
- Andrew Green, Director of Finance
- Vic Erganian, City Treasurer

While the Task Force concerned itself with the unique challenge associated with the FPRS, there was recognition that the future sustainability of government-sponsored defined benefit pension systems, in general, is currently in question and that Pasadena should follow related developments closely and consider whether changes to the pension plan offered by the City, through CalPERS, should be made. The recent City Council workshop on CalPERS retirement was an excellent first step in this direction.

The Fire and Police Retirement System

The Fire and Police Retirement System was established by Article XV of the City Charter. The System provides benefits to former police and firefighters hired before 1977 (when the System was closed to new entrants) and their beneficiaries, which as of June 30, 2009 totaled 290 individuals. Those hired since that time as well as those who elected to transfer, are part of the California Public Employee Retirement System, CalPERS.

The System is overseen by a board consisting of five members, comprised as follows: One member from the City Council, two members who are retired members of the System – one from Police and one from Fire, and two qualified electors of the City not otherwise connected with the City's government. Typically the selection to fill these two community seats has been handled much in the same way that the City Council selects citizens to sit on other boards, commissions and committees i.e., the Mayor advises the Council of the opportunity and suggestions are taken under advisement with the Mayor responsible for the final selection.

The Board has a fiduciary responsibility to the members of the System and meets monthly to review the performance of investments and take other actions associated with the proper functioning of a retirement system. The System has a staff of 1.25 FTEs with offices in City Hall and contracts with the firm of Mercer Consulting to provide professional advice in allocating assets and selecting particular investments. The System also contracts with P3 Actuaries for actuarial services.

Background

It appears that the System operated well and without issue prior to 1960. However, in that year the City Charter was amended to provide for a Cost of Living Adjustment (COLA) in addition to the basic monthly benefit for members of the System. The COLA was calculated to adjust the basic monthly benefit by the annual percentage change in the consumer price index. The COLA benefit contained no cap or limit; it was fully adjustable based on changes in the consumer price index.

After dramatic increases in the COLA, and through an agreement with the fire and police unions, the System was modified to: (1) Increase contribution rates for both the City and System members; (2) close the System to new employees, and (3) give existing participants an option to remain in the System or to join CalPERS. Few existing participants elected to join CalPERS and the modifications proved inadequate to address the continuing rise in the COLA benefit.

In 1981 a citizen's committee suggested substantial changes to the System. The proposed changes capped future COLA increases and/or decreases at 2%. In June, 1981, the voters approved the amendments to the Charter limiting the COLA benefits.

The Pasadena Police Officers Association filed suit claiming the 1981 amendments impaired the vested rights of its members. The City argued that the changes were imposed on a prospective basis only and on a pro rata basis only. Under the changed plan, an employee that retired after 20 years of service, working for 10 years with no cap on the COLA benefit and the other 10 years with the cap on COLA benefits would get 50% of his benefits with no COLA cap and 50% with the COLA cap.

The Appellate Court, in ruling on the case (*Pasadena Police Officers Association v. City of Pasadena* (1984) 147 Cal.App.3d 695), restated the long standing rule in California which established that a public employee's pension constitutes an element of compensation and that the right to pension benefits vests upon the acceptance of employment even though the right to immediate payment of a full pension may not mature until certain conditions are satisfied. Such a pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity.

The Appellate Court then invalidated the modifications and ruled that the imposition of the COLA cap was a substantial impairment of the vested contractual right on which the employees and retirees had relied and for which they had worked. Because the City had not provided "a comparable new advantage" to the affected employees and retirees, any substantial modification of the COLA benefit was invalid.

By the late 1990s the uncapped COLA and the failure to properly fund the System at an actuarially appropriate level, resulted in an actuarial funding level, i.e., the value of assets compared to the then present value of future benefits, of approximately 30% (Determining just how much of this was attributable to changes in the COLA/inflation and lack of proper funding by the City was not determined as the focus of the Task Force was on solving the current problem and not laying blame for the past). Although beneficiaries continued to receive their full benefit payments, this low level of funding called into question the future solvency of the System and was well below what would be considered adequately funded.

In 1999, as a result of negotiations between the City and the System, a Contribution Agreement (Exhibit 1) was entered into whereby the City agreed to issue $100 million in pension obligations bonds and transfer the proceeds to the System, in order to increase the actuarial funding level to 70%. The City also agreed to increase this funding level by ½% each year for twenty years, in order to reach a funding level of 80%, and to make supplemental contributions to the System, based on a specific formula, in the event the System's actuarial funding level fell short of the annual target.

Underlying this arrangement was the notion that the City could borrow at low interest rates and that the System would invest the proceeds in a mix of investments including equities, which would yield a greater return, thus achieving positive arbitrage and reducing the overall cost to the City.

Pursuant to the Contribution agreement, the economic assumptions for inflation and investment return are an average of those used by the county retirement systems in California covered under the County Employees Retirement Law of 1937 and include:

- Imperial
- Los Angeles
- Mendocino
- San Diego
- Dan Bernardino
- Sacramento
- Tulare
- Ventura
- Contra Costa
- Sonoma
- Alameda
- Marin
- Santa Barbara
- San Joaquin
- Stanislaus
- Fresno
- San Mateo
- Kern
- Orange Merced

These '37 Act Counties as they are commonly referred to are "open" systems, meaning current employees of each county are active participants in their respective system and presumably so will future employees.

The bursting of the Tech Bubble in the year 2000 significantly reduced the value of the System's investment portfolio and a widening gap was created between the actuarial value of the System's assets, which uses a multi-year smoothing formula, and the actual market value of those assets. This led to a dispute between the City and the System as to the amount of supplemental contributions necessary to keep the System funded consistent with the terms of the Contribution Agreement.

In 2004, the dispute was settled by way of a Settlement and Release Agreement (Exhibit 2) pursuant to which the City issued an additional $40 million in pension obligation bonds, again providing the proceeds to the System.

Although a General Fund obligation, the source of funding for the debt service payments on the 1999 and 2004 pension obligation bonds as well as supplemental contributions to the System has been tax increment dollars from the City's Downtown redevelopment project area. This was made possible as a result of special legislation, Senate Bill 481, passed on behalf of the City in 1987 which authorized the City's redevelopment agency to repay prior General Fund advances to the Downtown Project Area for the purpose of funding supporting the System.

The funding mechanism established by SB 481 has worked well in that the continued growth of assessed value in the Downtown Project Area has been more than sufficient to cover the debt service on the pension bonds, provide the supplemental contributions required to date and generate a reserve fund of tax increment dollars to be used for future obligations to the System. However, SB 481 will expire on December 31st 2014 and even if the legislation could somehow be extended, which is highly unlikely given the current climate in Sacramento, the actual debt between the City and the

Redevelopment Agency will be extinguished at roughly the same point. As a result, the flow of funds used to support the City's obligation to the System will cease.

After the expiration of SB 481 the General Fund will be required to make the debt service payments on the pension bonds as well as provide supplemental contributions to the System, which are projected to rise considerably over the next few years and then trail off as the number of participants in the System declines. The attached worksheet (Exhibit 3) projects the impact through the year 2074 when it is anticipated that there will no longer be participants in the System.

In regard to the worksheet the following should be noted: 1) the 1999 and 2004 pension bonds each have a mandatory tender (i.e., balloon payment) due in May 2015, which in combination totals $81 million. The worksheet assumes that the bonds will be re-amortized over a seven year period. It is possible to re-amortize over a longer period, thus reducing the annual payments, but the total expenditure over the life of the financing would also rise. The additional worksheets provide examples of the impact over varying terms. 2) The supplemental contributions identified in the column labeled the same are based on the most recent actuarial valuation of the System (June 30, 2009) and will increase or decrease depending on the investment results of the System.

As indicated by the worksheet, given current projections the total cumulative impact on the General Fund through the year 2074 is estimated at approximately $215 million. Stated another way, using the current actuarial assumptions of an 8% annual return and inflation of 3.8% the City would have to provide the System $40.2 million today to reach a 90% funding level or $58 million to achieve 100% funding. Should inflation be higher and/or investment returns lower, the total amount needed would rise. In addition, the City will still have to the pay debt service on the outstanding pension obligation bonds until the debt is paid off.

Exhibits 4 and 5 are the Projected Cash Flow for the System and Projected Supplemental Contributions required of the City, both of which are taken from the recent actuarial valuation. As discussed previously, the System's annual benefits and the amount of supplemental contributions are projected to decrease considerably over time as the number of beneficiaries decline; however, supplemental contributions are projected to exceed $10 million annually through 2021 using the current actuarial assumptions.

Adding to the challenge has been the impact of recent stock market declines on the value of the System's portfolio. For the year ending June 30, 2009 the System had a negative return of 20.2%, which comes on top of a loss of 7.6% for the prior year.

As mentioned above, the System uses a smoothing method whereby gains/losses are spread over a five year period. Using this smoothing method and thanks to prior positive returns, the System actually gained 1.7% from an actuarial point of view for the period ending June 30, 2009; nevertheless, this was still well below the 8% target. This difference translates to an actuarial funding deficit of $12.9 million. In accordance with

the Contribution Agreement the City covers the funding deficit with a supplemental payment. The formula for the supplemental payment requires the City to pay the first $3 million of any deficit plus 20% of any remainder in the year it occurs, which translates to $4.98 million in 2009. The balance of the deficit will be made up over the next few years and added to any additional supplemental contributions that may be required.

In addition to understanding all of this the Task Force spent time reviewing the workings of the System i.e., the benefit structure, and the Contribution Agreement between the City and the System. In this regard, the services of Ira Summer, actuary for the System, are to be acknowledged as well as the cooperation of the FPRS Board. Mr. Summer provided a variety of information which was most helpful to the Task Force in furthering its understanding. This information is attached as Appendix A.

Task Force Recommendations

The challenge facing the City in meeting its commitment to the FPRS is daunting and there is no simple solution. Perhaps, one was thought possible upon the advent of SB481, or the issuance of the first $100 million of pension obligation bonds, but reality has proven otherwise. The following recommendations can only mitigate impacts, not avoid them altogether; nevertheless, they represent important steps that should be taken immediately to address this critical issue.

- **Establish a much closer working relationship with the FPRS Board.**

The City and the System have common interests; specifically ensuring retirees and their beneficiaries receive the benefits they are entitled to. Unfortunately, the past relationship appears to have been rather acrimonious, which has benefited neither party. The recommendations of the Task Force are predicated on the establishment of a meaningful working relationship between the City and the System. The benefits of such have already been evidenced, as recently the FPRS Board was called upon to consider implementing "corridors" (a means of bringing the market value of assets in line with their actuarial value by requiring an additional supplemental contribution from the City). Such action would have increased the City's supplemental contribution in calendar year 2009 from $4.9 million to roughly $8.9 million. It is believed that the ultimate decision of the Board to not invoke corridors was, in part, influenced by discussions with the City.

- **Utilize existing SB481 reserve funds to increase plan assets and reduce volatility of the System's investment portfolio.**

Currently the annual actuarial valuation of the System takes into account only those assets under management of the System. However, the City is currently holding approximately $33.8 million in SB481 reserve funds representing tax increment funds from the Downtown Project Area over and above what is needed for debt service on the pension obligation bonds and the annual supplemental contributions in the current year. Pursuant to the Contribution Agreement, these funds may not be used for any purpose

other than meeting the City's obligation to the FPRS. Adding these funds to the actuarial base of assets could significantly improve the funding ratio of the system and reduce supplemental contributions over the next few years.

The issues with this approach are two fold. First, should the City or the System hold these assets and how should they be invested. Given that the City has twice provided FPRS the proceeds of pension bonds ($100 and $40 million respectively) only to see the principal eroded as a result of market losses, it is understandable there may be reluctance to hand over the only source of funds currently shielding the General Fund from direct contributions to the System. It is recognized that any final determination will be the result of negotiations between the City and the System. However, some considerations in this matter include the following.

Based on the City's investment policy, were it to hold the funds they would be invested more conservatively then the System's current asset allocation. This would work to reduce the overall risk profile of the System's portfolio but it may also fail to take advantage of current market conditions.

In the event the City provided the funds to the System there should be some agreement that they are to be co-managed by the City and the System. This could be an important first step towards a more coordinated effort recommended by the Task Force. The Task Force did not take a firm position on whether or not to provide these funds to the System, knowing that it would be subject to negotiation; however, the clear bias was to retain some level of control.

- **Amend the Contribution Agreement to decouple from the '37 Act Counties and allow for periodic mutually agreed upon changes in targeted investment return and inflation factors.**

The Contribution Agreement makes several references to the '37 Act Counties. For example, the 8% expected rate of return is based on the average of the '37 Act Counties and the provision for implementing "Corridors" is also based on the status of the '37 Act Counties.

Given that FPRS is a closed system with no active members and a guarantee from the City to ensure its solvency, its character is much different from the '37 Act Counties. As such FPRS should be decoupled from these other systems and be managed in a fashion fitting its unique circumstances.

Decoupling from the '37 Act Counties would allow the City and FPRS to establish assumed rates of return, based upon a mutually agreed investment strategy, and expected inflation rates. These rates should be agreed to annually by FPRS and the City.

- **Reconsider Investment Strategy**

Pursuant to the Contribution Agreement the System has been seeking to achieve an 8% investment return and it has established an asset allocation intended to achieve this result. However, the System has met or exceeded this target in only four of the past ten years. Much of this has to do with overall market conditions including two significant market corrections over the same period coupled with the effect of systematic withdrawals to make benefit payments. In total over the last decade the System had absolute returns of a mere 1.5%. Whereas with the benefit of hindsight, had the funds been invested in the same manner as the City's Power Reserve Portfolio, which seeks to preserve principal and achieve moderate gains, the fund would have returned 5.2% and currently have $32.6 million more.

The FPRS has a much shorter time horizon than CalPERS or any of the '37 Act counties and changing contribution rates and smoothing assets over a longer period is simply not an option. Consequently, the investment strategy needs to become more strategic, taking into account current and likely near term market conditions, to strike the right balance between risk and return.

- **Consolidate administrative functions of the System within the City's Finance Department.**

FPRS has a staff of 1.5 FTE and recently, Mary Smith, the System's Secretary retired and is back working as a retiree. To reduce the cost of overhead for the System and achieve overall economy of scale the administrative functions of the System should be assigned to existing staff within the City's Finance Department, much in the same way as the City's Deferred Compensation Plan is managed.

- **Request that the System undertake a new selection process for financial advisor and that this process be repeated at least every three to five years.**

FPRS has been using the services of Mercer Consulting as investment advisor for approximately ten years. Mercer's annual fee for service is approximately $100,000. In order to ensure the System is receiving the best possible investment advice and that fees for service are reasonable these services should the subject of a competitive selection process on a periodic basis such as every three to five years.

- **Consider "buy-outs"**

The Task Force considered whether it would be possible to provide buy-outs to members as a means of reducing future obligations. However, given the fairly generous nature of the benefit structure and without further analysis it is unclear whether this is a viable option. It is recommended that the City work with FPRS to determine whether a mutually beneficial program could be established.

- **Pursue new revenue sources to provide for the System while shielding the General Fund.**

Although the Task Force did not focus specifically on this issue it was generally understood that through the use of Redevelopment the City may be able to identify a project(s) that would generate new revenues for the General Fund which could in turn offset the obligation to the System such as a new office building or parking garage. The Task Force urges the City to pursue these opportunities.

For example, using Redevelopment funds it is understood that the City could develop a project within the Downtown project area such as an office building to house city offices, a private-use project such as a hotel or office building or some combination thereof that generates some positive cash flow to be assigned to the City's General Fund. These revenues could in turn be utilized to either pay required supplemental contributions to the System and/or support a third, and final, pension obligation bond to fully fund the System.