Agenda Report

August 28, 2017

TO: Honorable Mayor and City Council

THROUGH: Finance Committee

FROM: Department of Finance

SUBJECT: **ESTABLISHMENT OF INTERNAL REVENUE SERVICE (IRS) SECTION 115 TRUST PUBLIC AGENCY RETIREMENT SERVICES (PARS) PENSION RATE STABILIZATION PROGRAM**

RECOMMENDATION:

It is recommended that the City Council:

1. Find that the proposed action is not subject to the California Environmental Quality Act (CEQA) as defined in Section 21065 of CEQA and Section 15378 of the State CEQA Guidelines and, as such, no environmental document pursuant to CEQA is required; and

2. Adopt a resolution authorizing the establishment of the PARS Retirement and Post-Employment Benefits Trust program to pre-fund pension obligations; and

3. Authorize the City Manager or the Director of Finance to execute the Trust Agreement, the Adoption Agreement, the Master Plan Document, the Administrative Services Agreement, the Trustee Fee Agreement, and other documents related thereto. Competitive bidding is not required pursuant to City Charter Section 1002(F) contracts for professional or unique services; and

4. Grant the proposed Section 115 Trust from the competitive selection process pursuant to Pasadena Municipal Code Section 4.08.049B, contracts for which the City's best interests are served.

EXECUTIVE SUMMARY:

On June 12, 2017, City Council directed staff to bring forward for approval the establishment of a Section 115 Trust in order to pre-fund the City's pension and other Post-Employment Benefits (OPEB). The proposed action is consistent with Council's provided direction in regard to the proposed strategy to address the City's unfunded pension and OPEB liabilities.

BACKGROUND:

In 2012, the Government Accounting Standard Board (GASB) issued Statement No. 68, *Accounting and Financial Reporting for Pensions.* GASB 68 requires that government employers that sponsor defined benefit plans (i.e. CalPERS) must recognize a net pension liability (unfunded accrued liability) on their balance sheet. This is the difference between the City's total pension liability (actuarial accrued liability) and actual plan assets. GASB 68 became effective for the 2014-15 fiscal year. To address the GASB 68 net pension liability figure, the City's only prior option was to commit additional funds to CalPERS (in excess of its annual required contributions) to reduce its unfunded liability; however, pension trusts formed under Internal Revenue Service (IRS) Section 115 established that cities could create separate trusts to "pre-fund" their CalPERS unfunded liabilities. This provides cities with an alternative to sending additional funds to CalPERS. It allows greater local control over pension assets and it allows the investment of the assets in the trust by a professional fund management team to be selected and monitored by the City with future excess contributions transferred to CalPERS at the City's discretion.

A Pension Rate Stabilization program through a Section 115 trust offers the following benefits:

- Contributions placed in an exclusive benefit trust could address the City's net pension liability;
- Investment flexibility with a Section 115 trust compared to restrictions on general fund investments (Govt section 53600);
- Increased risk diversification of plan assets through diverse asset management;
- Investments can be tailored to the City's unique demographics and desired risk tolerance;
- Oversight and control of fund management selection (i.e. monitoring of performance and ability to replace fund management based on performance criteria);
- Increased flexibility on use of trust assets (i.e. trust asset can be accessed at any time as long as the assets are used to fund the City's pension obligations and are used to defray reasonable pension plan-related expenses);
- Lower investment management and administrative expenses compared to CalPERS;
- Potential for positive rating agency and investor consideration.

Finance staff solicited proposals from PARS and PFM, the two firms that have obtained IRS private ruling letters related to Section 115 trusts. After a careful assessment of both proposals, staff recommends participation in the Pension Rate Stabilization Program offered by PARS based on its experience, number of clients, historic returns, flexibility of investments and fees.

To date, 92 public agencies have adopted the Pension Rate Stabilization Program (PRSP) through PARS including the cities of Glendale, Manhattan Beach, Rolling Hills, Palo Alto and many others.

In an effort to help public agencies address and manage their GASB 68 liability, PARS has developed the PARS Section 115 Trust Pension Rate Stabilization Program. PARS has assembled leading professionals to provide the City with the necessary services required under one program to pre-fund pension liabilities through the IRS-reviewed program. The program has been established as a multiple employer trust so that public agencies, regardless of size, can join the program to receive the necessary economies of scale to keep administrative fees low and avoid setup costs. The trust permits the City, under federal and state law, to invest in a more diversified array of investments to maximize investment returns long-term. PARS has partnered with US Bank to serve as trustee and its sub-advisor HighMark Capital Management, Inc., to provide investment management services for the program.

The City has two retirement plans for current employees through CalPERS: one to fund pensions for miscellaneous (non-safety employees), and one to fund pensions for safety employees (fire and police sworn personnel). As of the June 30, 2016 CalPERS valuation, the funding ratio of the City's miscellaneous plan dropped from 74.8% to 70.1% rate, and the funding ratio of the City's safety plan declined from 75.6% to 70.9%. As of June 30, 2016 valuation, the combined unfunded liability for these two plans was reported at $470 million, an increase of $93 million from the prior year while The City's total assets in the plans stood at over $1.1 billion, the same as the prior year.

Pension benefits are funded by employer and employee contributions and by investment earnings on those contributions. Numerous assumptions, including actuarial assumptions about employee and retiree populations and assumptions about investment returns, are used to determine the funding contributions required of the City.

In determining contribution rates, one of the most critical assumptions is the rate of return (ROR) on investments in the plans. CalPERS' annual rate of return assumption is 7.5 percent for the City's most recent FY2016 actuarial report. This rate will be adjusted downward beginning in FY18 as stated below. Assuming this rate of return is attained, funding of pension obligations would be derived 66 percent from investment gains and 34 percent from contributions by employers and employees. The actual ROR has been volatile over the past twenty years, where periods of gains have been followed by losses; however, the gains have not offset the significant losses over time. CalPERS' ROR was 2.4 percent in FY 2014-15, 0.61 percent in FY 2015-16, and 11.1% in FY 2016-17, averaging well below the assumed 7.5% ROR.

As a result of past performance, the long, low-interest rate environment, and a movement towards a risk-averse investment portfolio, the CalPERS board has approved a plan to reduce the assumed ROR from 7.5 percent to 7.0 percent over a three-year period, as follows:

- FY 2017-18: 7.375 percent
- FY 2018-19: 7.25 percent
- FY 2019-20: 7.00 percent

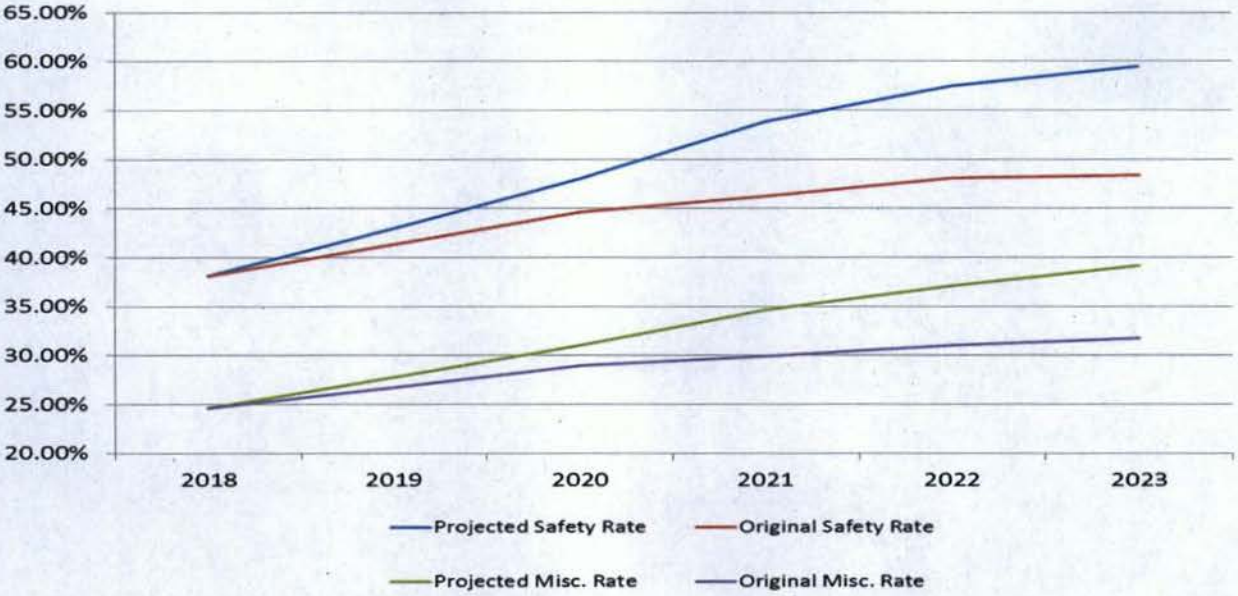
This development means that investment returns will be relied upon less and employer contributions relied upon more to fund pension obligations. This will compound existing pension funding challenges for Pasadena and all CalPERS member agencies. For Pasadena, its Miscellaneous Plan is currently 70.1 percent funded and its Safety Plan is 70.9 percent funded. As the assumed ROR decreases over the next three years, the funding levels of each plan will drop, thus putting the City farther behind in meeting pension obligations, if no additional action is taken.

To address this growing concern, in 2013, the Public Employee Pension Reform Act (PEPRA) was enacted at the state level, which required contracting agencies to implement a less generous pension formula for new hires who are new CalPERS members. PEPRA included new restrictions on pensionable compensation designed to limit the accrual of unfunded liabilities over time. As these newer formulas only apply to those hired after the effective date of PEPRA, there has been little immediate impact on the City's total pension costs; however, such changes will reduce future liabilities and costs over the long-term. Currently, about 21 percent of the City's workforce is covered under the new PEPRA formula.

In Pasadena, to help address the growing impact of pension costs, the City negotiated pension cost-sharing agreements with each of its bargaining groups. Currently all City employees covered by CalPERS are paying the employee portion, which was previously covered by the City. In addition, one bargaining unit, Pasadena Fire Fighters, is contributing an additional 3 percent towards the employer portion. It is anticipated that other bargaining groups will need to follow suit in paying more than just the employee portion. Although these cost-sharing agreements assist the City in paying the required annual payments to CalPERS, such arrangements do not provide any additional payment toward the City's unfunded liabilities.

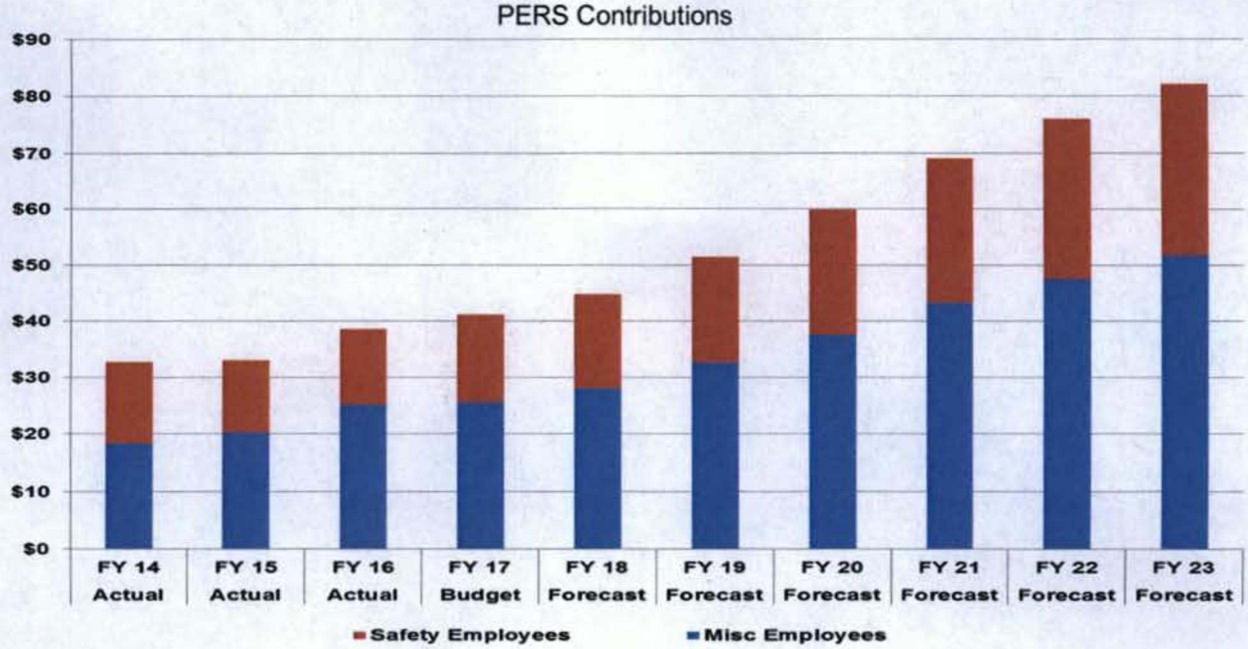
As stated above, CalPERS has been unable to consistently hit its investment return assumption and has taken formal action to gradually reduce the assumed rate of return. This, combined with the substandard average investment returns for the last several years, will result in an increase of millions to the City's unfunded liability. The end result is that the City is facing rapid growth in pension liabilities and required pension contributions.

The chart below depicts the CalPERS pension contribution rates as a percentage of payroll based upon the changes discussed above.



In terms of costs to the City over the next few years, for fiscal year 2018, the payment to CalPERS is projected to be $45 million of which the General Fund will be responsible for 56 percent or $26 million, growing to more than $81 million by 2023 - an 80 percent increase or nearly double where it stands today. Ominously, these projections, dire as they are, assume that CalPERS hits its earning target each and every year. Should it fall short, the total liability will rise correspondingly.

PERS Contributions



Other Post-Employment Benefits (OPEB):

In addition to CalPERS unfunded liabilities, the City has OPEB liabilities related to required retiree medical contributions resulting from providing of medical insurance for employees and retirees through the Public Employees Medical and Health Care Act (PEHMCA) of CalPERS. PEHMCA mandates a minimum monthly contribution be paid by local agencies towards the medical insurance of retirees. An OPEB valuation is required to be completed by the City to determine long-term liability of this benefit and subsequently report this liability on the City's financial statements. As of the most recent valuation completed in 2016, the City's OPEB liability was $54 million. The City is currently funding this expense on a pay-as-you-go basis of roughly $1.5 million per year. This approach does nothing to reduce the outstanding liability. In order to do so would require an annual contribution of $6 million annually.

COUNCIL POLICY CONSIDERATION:

This action supports the City Council's strategic goal to maintain fiscal responsibility and stability.

FISCAL IMPACT:

There is no fiscal impact related to establishing the recommended Section 115 trust without an initial deposit. Any deposit into the trust will reduce future pension contributions to PERS and have a positive impact on funding the city's actuarial accrued liability. Upon commencement of funding the trust, staff will retain an actuary to complete an actuarial analysis to determine the fiscal impact of the various funding levels of the trust and report back the results to the City Council.

Respectfully submitted,

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