Budget Engagement Commission

City of Arts & Innovation

TO: HONORABLE COMMISSIONERS **DATE: MAY 20, 2019**

FROM: FINANCE DEPARTMENT **WARDS: ALL**

SUBJECT: ESTABLISHMENT OF SECTION 115 PENSION TRUST FUND FOR FISCAL MANAGEMENT OF CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM LONG-TERM LIABILITY

ISSUE:

Receive and provide input on the establishment of a Section 115 Pension Trust Fund to help with the fiscal Management of the California Public Employees Retirement System long-term liability.

RECOMMENDATIONS:

That the Budget Engagement Commission:

1. Receive and provide input on the establishment of a Section 115 Pension Trust Fund to help with the fiscal Management of the California Public Employees Retirement System long-term liability; and

2. Recommend that the City Council approve the proposed establishment of a Section 115 Pension Trust Fund to help with the fiscal Management of the California Public Employees Retirement System long-term liability.

BACKGROUND:

Rising pension costs are the most pressing financial issue facing California public agencies. **The City's annual pension costs have risen from $51 million (27% of payroll) to an estimated $82 million (41% of payroll) over the last six years (FYE 2015 to FYE 2020)**. Increasing pension costs reduce the ability for the City to fund other operations, capital projects and grow reserves.

The City of Riverside has been a member of the California Public Employees Retirement System (CalPERS) since 1945. Both the City and current employees contribute to the CalPERS plan. The gap between what the City has already contributed and the benefits owed to retirees continues to grow due to market changes, an increased number of retirees, and longer life expectancies of retirees. This gap is what is known as the CalPERS unfunded pension liability.

The City of Riverside has two pension trusts with the California Public Employees' Retirement System (CalPERS): one to fund public safety employees and one for miscellaneous employees.

The trusts are funded by employer and employee contributions and by investment earnings on those contributions. In order to reach necessary funding levels to pay employee pensions, CalPERS establishes a set of actuarial assumptions to achieve those levels. One of the most critical assumptions in attaining full funding goals is the rate of return on investments in the trusts. CalPERS' current annual rate of return (ROR) assumption is 7.25 percent which will be lowered to 7 percent for the June 30, 2020 actuarial valuation.

Assuming this rate of return is attained, the funding of the pension obligations would be derived 66 percent from investment gains and 34 percent from contributions. If the 7.25 percent rate of return is not realized, contributions from employers and employees will have to increase in order to make up any investment shortfalls. Unfortunately, this ROR has not been consistently achieved by CalPERS. The outlook from the investment community and actuaries for a 7.25 percent annual rate of return is increasingly pessimistic. In fact, the average actual rates of CalPERS returns in the table below have fallen below expectations in several time periods.

Total Fund Market Value & Total Net Investment Return** 10-year Review (for FY end 6/30 (in billions)		
2018	$354	8.6%
2017	$326	11.2%
2016	$302	0.6%
2015	$302	2.4%
2014	$300	18.4%
2013	$258	13.2%
2012	$233	0.1%
2011	$238	21.7%
2010	$200	13.3%
2009	$181	-24.0%

* Public Employees' Retirement Fund (PERF)

** Net time-weighted rate of returns

As a consequence of poor investment performance; a long, low interest rate environment; and movement toward a more "risk averse" portfolio; the CalPERS board approved a plan to reduce the assumed ROR from 7.25 percent to 7.0 percent by July 2019 for the June 30, 2020 actuarial valuation. CalPERS' decrease in the ROR assumption will result in higher contribution rates for employers and employees.

DISCUSSION:

Collective Bargaining and Representation of Employees

The City maintains a strict commitment to collective bargaining which includes the requirement to meet and confer on any changes affecting wages, hours, promotions, benefits, and other employment terms. The City will not engage in activity that may be seen to run counter to the ability of the City and the Unions to communicate openly and honestly during the collective bargaining process, to find solutions that will ultimately benefit the City of Riverside. For simplicity, the City colloquially refers to this commitment as performing in "good faith" with the Unions and unrepresented employees alike.

Section 115 Pension Trust Fund

Until recently, the City's only option for reducing the unfunded actuarial accrued liability was to commit additional funds to CalPERS. Unfortunately, these funds would be subject to the same market volatility as the CalPERS investment policy, and the funds would not be accessible to the City for other pension expenses. In the last couple of years, a private letter ruling was received from the IRS that establishes that under Section 115 of the Internal Revenue Code, public agencies or municipalities could create a separate trust to "pre-fund" its CalPERS unfunded liability. This would provide an alternative to sending the funds to CalPERS, and would provide greater local control over the assets and investment portfolio management.

Staff conducted research and concluded that the advantages of establishing a Section 115 Pension Trust Fund (115 Trust) to act as a stabilizer of the City's annual required CalPERS employer contribution rates far outweigh the disadvantages of not doing so, and enables the City to prepare for and partially offset unexpected CalPERS rate increases and CalPERS market losses. Some of the advantages of the 115 Trust are the following:

1. **Complete local control over the assets**. The trust can be accessed at any time so long as the funds are used to pay the City's pension obligations.
2. **Lower Net Pension Liability**-contributions placed in the trust reduces the City's unfunded pension liability.
3. **Pension Rate Stabilization**-assets can be transferred to CalPERS at the City's discretion, which will help reduce or eliminate large fluctuations in employer contributions towards retirement benefits.
4. **Investment Flexibility**-the trust permits the City, under federal and state law, to invest in a more diversified array of appropriate investments to maximize returns on long-term investments, and reduce the City's liability.
5. **Investment Management**-Investment of plan assets can be managed by a professional fund management team, selected by and monitored by City staff.
6. **Potential for Improved Credit Ratings**-rating agencies may look favorably on actions to reduce post-employment obligations, since the City's growing pension obligations was Moody's main serious concern in its Annual Issuer Comment Report issued on May 18, 2018.

The City has identified three (3) agencies that provide professional investment advisory or management services: Public Agency Retirement Services (PARS), PFM Asset Management LLC (PFM), and Keenan.

A League of California Cities' Retirement System Sustainability Study and Findings (January 2018) revealed the following:

1. Rising pension costs will require cities over the next seven (7) years to nearly double the percentage of their General Fund dollars they pay to CalPERS. Between FY 2018-19 and FY 2024-25, cities' dollar contributions will increase by more than 50 percent.
2. For many cities, pension costs will dramatically increase to unsustainable levels;
3. Many cities face difficult choices that will be compounded in the next recession.

4. Tangible savings resulting from PEPRA will not have a substantial effect on city budgets for decades. According to recent actuarial information the City will not see noticeable changes until FY2034-35

According to the League, some things cities can do today are the following:

1. Develop and implement a plan to pay down the city's Unfunded Actuarial Liability (UAL). Possible methods include shorter amortization periods and pre-payment of cities UAL.
2. Consider local ballot measures to enhance revenues.
3. Create a pension rate stabilization program: Establishing and funding a local Section 115 Trust Fund can help offset unanticipated spikes in employer contributions.
4. Change service delivery methods and levels of certain public services.
5. Use procedures and transparent bargaining to increase employee pension contributions.
6. Issue a pension obligation bond (POB). However, financial experts including the Government Finance Officers Association (GFOA) strongly discourage local agencies from issuing POBs. Moreover, this approach only delays and compounds the inevitable financial impacts.

This report deals with part of the third item listed above that can be done: establishing a local Section 115 Trust Fund to help offset future spikes in employer contributions.

A Section 115 Trust Fund is a vehicle for segregating City funds from general assets for the purpose of funding essential governmental functions. Funds placed in a 115 trust are irrevocably committed for the essential City function(s) specified in the applicable trust agreement (e.g., pension obligations). Therefore, the monies held in such trusts can be invested in accordance with the rules governing such special purpose accounts. Thus, by setting aside funds in a 115 trust, the City can potentially earn a higher rate of return on monies set aside for future pension obligations.

Through the use of a 115 Trust the City maintains complete control over the assets in the Trust, as opposed to sending the money directly to CalPERS to address unfunded pension obligations. The City loses control or oversight over the funds forever once the funds are sent to CalPERS, and CalPERS handles all aspects of the pension obligation. With a Section 115 Trust, the City can determine the level of risk taken in the investment portfolio and can determine the Trust's asset allocations. Assets can be transferred to CalPERS at the City's discretion, which will help reduce or eliminate large fluctuations in employer contributions towards retirement benefits as noted in the prepayment of base option. The Trust permits the City, under federal and state law, to invest in a more diversified array of appropriate investments to maximize returns on long-term investments, and reduce the City's liability; and investment of plan assets can be managed by a professional fund management team, selected by and monitored by City staff.

FISCAL IMPACT:

There is no direct fiscal impact associated with the receipt of this report. Additionally, the establishment of a Section 115 Trust Fund has no immediate financial impact. The allocation of FY2017-18 carryovers identified in the amount of approximately $4.5 million can be used as the initial funding source of the Section 115 trust once it has been established.

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Attachment:	Presentation