PUBLIC AGENCY RETIREMENT SERVICES **PARS**

TRUSTED SOLUTIONS. LASTING RESULTS.

PENSION RATE STABILIZATION PROGRAM (PRSP)

PARS (Public Agency Retirement Services) is pleased to offer the Pension Rate Stabilization Program (PRSP), an innovative IRC Section 115 irrevocable trust designed exclusively for CA public agencies to prefund pension costs and address pension liabilities. The PARS PRSP allows your public agency to securely set aside funds, separately and apart from state or county retirement systems, in a tax-exempt prefunding vehicle to mitigate long-term contribution rate volatility. Participating public agencies maintain local control over assets held in the trust and can determine the appropriate goals and risk tolerance level for the investments. The PARS PRSP is a creative solution for setting aside and safeguarding reserve monies to help deal with rising pension costs.

WHY PREFUND YOUR PENSION OBLIGATIONS WITH THE PARS PRSP?

- Contributions into the trust can be used to help address future pension liabilities, which per GASB 68 is required to be shown on your agency's financial statements;
- Assets can be accessed to offset contribution rate increases (rate stabilization) or as a rainy day fund during adverse budgetary or economic conditions;
- May favorably impact a public agency's credit rating;
- Prudent use of reserve funds by applying them directly toward your public agency's increasing retirement costs; and
- As an irrevocable, exclusive benefit trust, the investment of assets can be diversified in order to potentially achieve a greater rate of return than your general fund (CA Government code section 53216.1).

ADDITIONAL FEATURES OF THIS CUTTING-EDGE PROGRAM INCLUDE:

- Comprehensive, turn-key services that include consulting, record-keeping, reporting, compliance, trustee/custodian services and coordination of investment management;
- Multiple-employer trust structure that brings investment and administrative economies of scale with no risk sharing or set-up costs;
- Legally vetted program with exclusive IRS Private Letter Ruling (PLR);
- Full flexibility and local control over investment options, including both discretionary and directed trustee approaches;
- Can prefund OPEB benefits in the same trust; each is accounted for separately; assets aggregate for lower fees;
- Signature-ready documents that enable fast, streamlined implementation process; and
- Hands-on support from PARS and investment management partner service teams including a dedicated portfolio manager who takes on fiduciary responsibility, provides onsite reviews, and is available to you at anytime via cell phone access.

FOR MORE INFORMATION, PLEASE CONTACT:

MITCH BARKER
Executive Vice President
mbarker@pars.org or
(800) 540-6369 ext. 116

DENNIS YU
Executive Vice President
dyu@pars.org or
(800) 540-6369 ext. 104

KEVIN O'ROURKE
Senior Consultant
kevin@kolgs.com or
(707) 249-5356

RACHAEL SANDERS
Manager, Retirement Programs
rsanders@pars.org or
(800) 540-6369 ext. 121

JENNIFER MEZA
Supervisor, Client Services
jmeza@pars.org or
(800) 540-6369 ext. 141

Visit us online at www.pars.org

PARS CLIENT LIST – PRSP (126)

UPDATED: FEBRUARY 2018

CITIES & TOWNS

City of Alameda
City of Bell Gardens
City of Beverly Hills
City of Brea
City of Brisbane
City of Burlingame
City of Capitola
City of Chino Hills
City of Coronado
City of Cypress
City of Daly City
City of Dublin
City of El Centro
City of El Segundo
City of Escondido
City of Fountain Valley
City of Fullerton
City of Glendale
City of Half Moon Bay
City of Healdsburg
City of Hercules
City of Huntington Beach
City of La Mesa
City of Lake Forest
City of Lodi
City of Manhattan Beach
City of Morgan Hill
City of Napa
City of National City
City of Norwalk
City of Oakley
City of Oroville
City of Palo Alto
City of Pasadena
City of Pico Rivera
City of Port Hueneme
City of Rancho Cucamonga
City of Redwood City
City of Rohnert Park
City of Rolling Hills
City of San Ramon
City of Santa Ana
City of Santa Clara
City of Sausalito
City of Solana Beach
City of Stanton
City of Stockton
City of Tustin
City of Union City
City of Upland
City of Vallejo
City of Villa Park
City of West Covina
City of West Sacramento
City of Westminster
City of Yuba City
Town of Colma
Town of Los Altos Hills
Town of Los Gatos
Town of Tiburon
Town of Yountville
Town of Yucca Valley

COUNTIES

County of Humboldt
County of Kings
County of Nevada
County of Placer
County of Plumas
County of Riverside
County of San Benito
County of Siskiyou
County of Solano
County of Sutter

EDUCATION DISTRICTS

Citrus CCD
Coast CCD
Grossmont-Cuyamaca CCD
Hartnell CCD
Marin CCD
San Bernardino CCD
San Luis Obispo CCD (Cuesta College)
Victor Valley CCD
Yosemite CCD
Bass Lake Joint Union ESD
Calistoga Joint USD
Campbell Union HSD
Corning Union ESD
Coronado USD
Cotati-Rohnert Park USD
Fontana USD
Hesperia Unified SD
Lakeside Union SD
Lemon Grove SD
Natomas USD
Ocean View SD
Ontario-Montclair SD
Placer Union HSD
River Delta USD
San Marino USD
Santa Rita Union SD
Visalia USD
Whittier City SD

SPECIAL DISTRICTS

Alameda County MAD
Central Contra Costa Sanitary District
Delta Diablo (Sanitation District)
East Bay Regional Park District
East Orange County Water District
El Dorado Hills County Water District
Fallbrook Public Utility District
Goleta West Sanitary District
Great Basin Unified APCD
Humboldt Bay Municipal Water District
Mesa Water District
Mojave Desert AQMD
Montecito Fire Protection District
Moraga-Orinda Fire Protection District
Napa County MAD
Nevada County Consolidated FD
Novato Sanitary District
Rancho Cucamonga Fire PD
South Coast Water District
Southern Marin Fire Protection District
Superior Court of CA - County of Kern
Sweetwater Springs Water District
Three Valleys Municipal Water District
Twentynine Palms Water District
West Bay Sanitary District
Yorba Linda Water District

PUBLIC AGENCY RETIREMENT SERVICES PARS
TRUSTED SOLUTIONS. LASTING RESULTS.

Agenda Report

June 12, 2017

TO: Honorable Mayor and City Council

THROUGH: Finance Committee

FROM: City Manager and Director of Finance

SUBJECT: **PROPOSED FISCAL STRATEGY TO ADDRESS CURRENT AND FUTURE FINANCIAL LIABILITIES**

RECOMMENDATION:

It is recommended that the City Council:

1. Find that the recommended action is exempt from the California Environmental Quality Act ("CEQA") pursuant to State CEQA Guidelines Section 15061(b)(3); and

2. Approve the following actions to address current and future financial liabilities of the City. Specifically:

   a. Direct staff to return to City Council with a revised Fund Balance Policy which would cap the General Fund Emergency Contingency Reserve at 15% of appropriations and create a General Fund Operating Reserve of 5% of appropriations;

   b. Direct 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), with an initial deposit of $12 million from unassigned General Fund Fund Balance; $10 million towards pensions and $2 million towards OPEB;

   c. Approve an allocation of $1 million of unassigned General Fund Fund Balance to the Workers Compensation Fund; and,

   d. Approve an allocation of $1 million of unassigned General Fund Fund Balance to the General Liability Fund.

BACKGROUND:

The General Fund is the City's most important fund, providing the essential City services of Police and Fire response as well as other important services including Parks, Recreation, Public Works and Libraries. Appropriations in the General Fund total nearly $240 million in the current and proposed fiscal year. Most importantly, as a result of mid-year budget reductions of $2.1 million made last fall and another $2 million programmed into the Recommended Operating Budget, along with some modest projected revenue growth, the budget for Fiscal Year 2018 is balanced without the need to rely on reserves.

However, as discussed at length as part of the Fiscal Year 2017 and Fiscal Year 2018 budget process, there are certain factors, most significantly future increased pension contributions to CalPERS, which are expected to put considerable strain on the City's General Fund over the next several years. Other liabilities such as those related to Other Post-Employment Benefits (OPEB) are also rising. Additionally, as discussed during deliberations on the Capital Improvement Program Budget, there are numerous unfunded capital needs within the City such as, upgrading/replacing outdated and aging fire stations and improvements to other municipal facilities.

CalPERS

The City has two retirement plans for current employees through the California Public Employee Retirement System (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, 2015 CalPERS valuation, the City's combined unfunded liability of these two plans was $377 million. The City's total assets in the plans stood at over $1.1 billion as of this same period.

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' current annual rate of return assumption is 7.5 percent. Assuming this rate of return is attained, then 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, and 0.61 percent in FY 2015-16.

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:

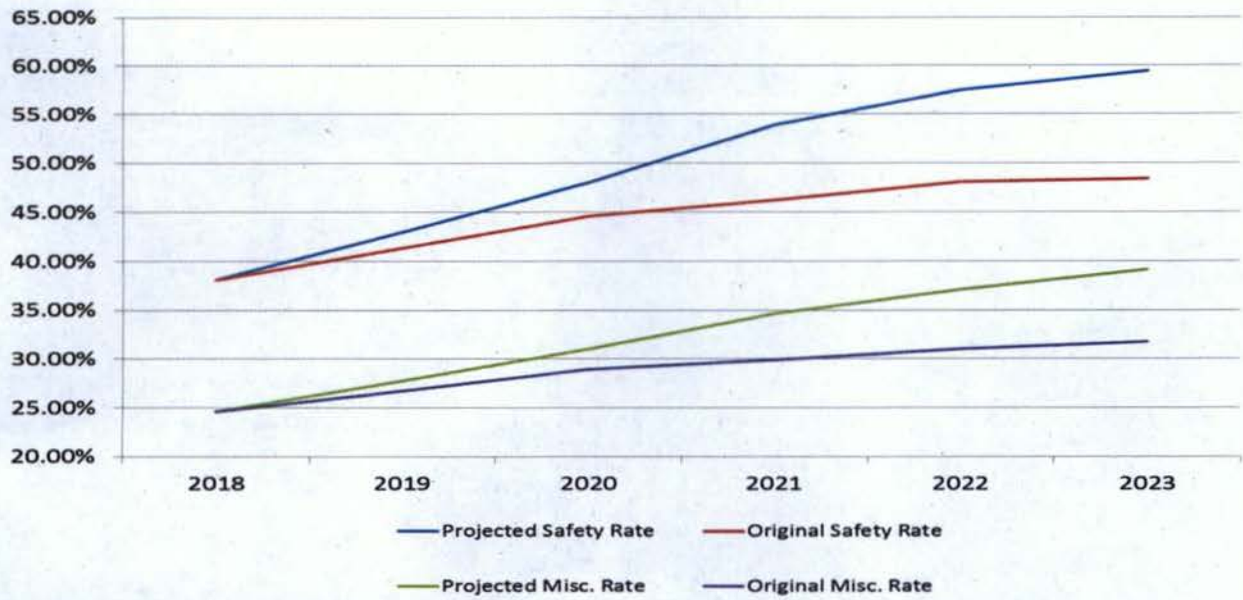
- FY 2017-18: 7.375 percent
- FY 2018-19: 7.25 percent
- FY 2019-20: 7.00 percent

This development means that investment returns will be relied upon less, and employer contributions relied upon more, in order 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 74.8 percent funded, and the Safety Plan is currently 75.6 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.

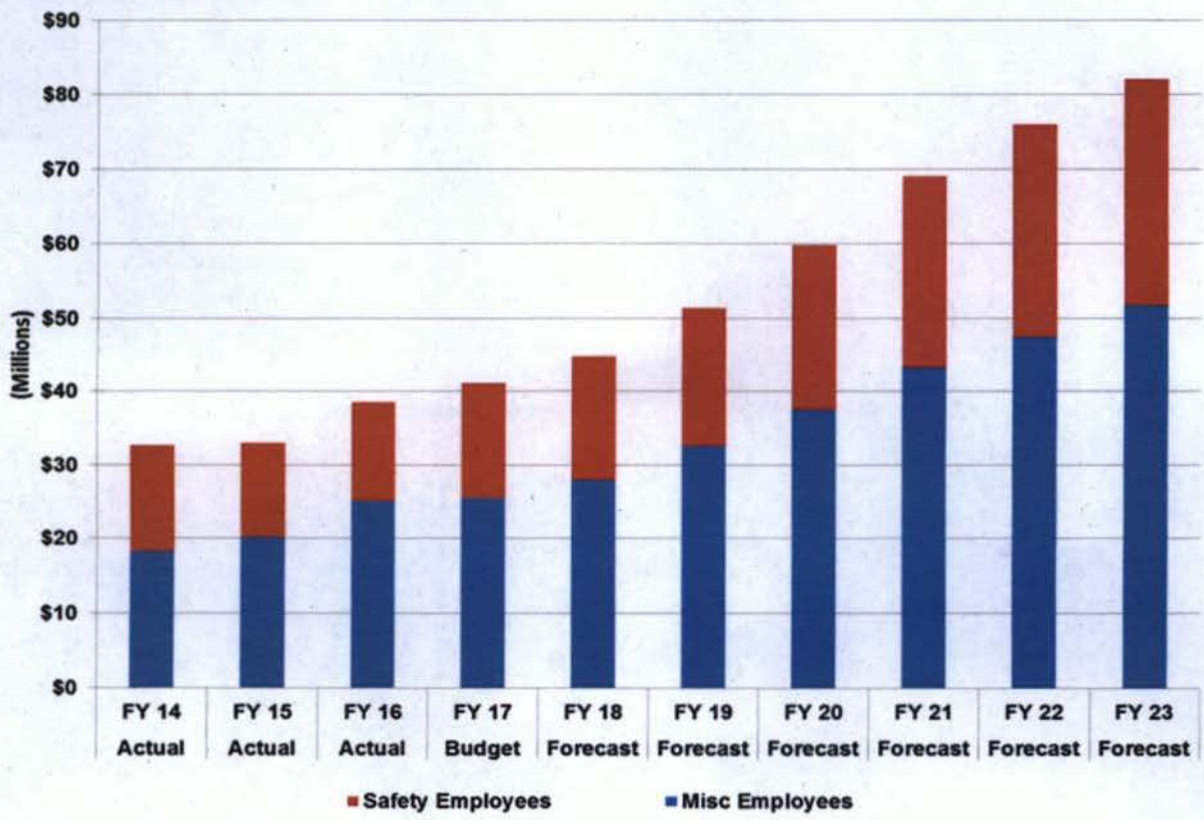
To address this growing concern, in 2013, the Public Employee Pension Reform Act (PEPRA) was enacted at the state level, which required contracting agencies to implement a less generous pension formula for new hires that are new CalPERS members. PEPRA included new restrictions on pensionable compensation, 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% 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 has 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% 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 investment return for fiscal year 2016 of only 0.61 percent, will result in an increase of at least $100 million 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 following chart 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% ($26 million), growing to more than $81 million by 2023; an 80% 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.



OPEB
In addition to CalPERS unfunded liabilities, the City has Other Post-Employment Benefits (OPEB) liabilities related to required retiree medical contributions resulting from providing 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 per year.

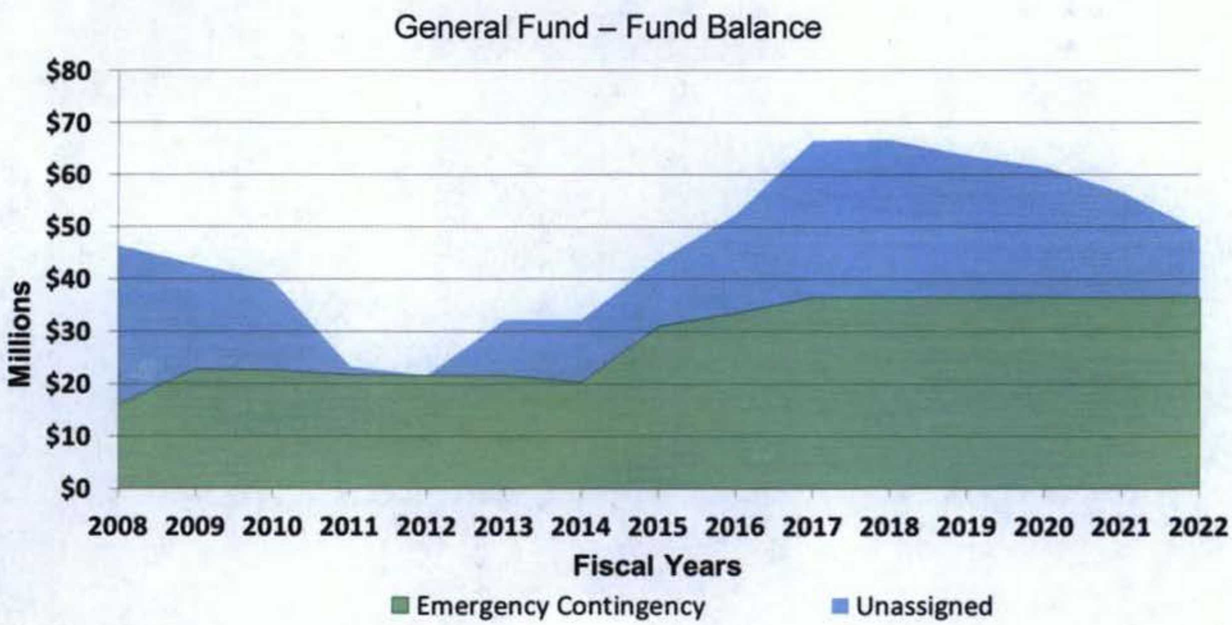
Capital Needs
As the City Council is aware, the current five-year capital improvement program has a list of future unfunded projects totaling almost $300 million along with dozens of current projects that are underfunded. As presented with the Capital Improvement Program Budget, the annual funding needed to maintain streets at an acceptable level is $7 million, and even with the recently approved increase to Gas Tax under Senate Bill 1, the City will have a shortfall in funding of $3 million annually. In terms of facilities, virtually all of the City's buildings need additional funding for proper maintenance and several of the City's fire stations need to be renovated or reconstructed. The estimated cost for that work is in excess of $100 million. Additionally, the City's public safety radio system is in need of replacement with an estimated cost of approximately $10 million.

The City's Current Fiscal Condition
The challenges outlined above, while daunting, can be effectively managed provided the City continues its longstanding practice of taking prudent, meaningful action to ensure financial stability.

In addition to having a balanced General Fund budget for Fiscal Year 2018, the City maintains an Emergency Contingency Reserve to be used in the event of a fiscal emergency such as in the wake of natural disaster. For a number of years, this Reserve was maintained at a level of 10% of appropriations. In 2011 the City Council adopted a policy to increase the Reserve over time to 20% of appropriations. Currently, the Reserve stands at $36.45 million, representing 15.3% of current year appropriations.

Fortunately, in addition to the committed Reserve, the City is projected to have approximately $30 million of unassigned fund balance as of June 30, 2017. This total includes the $19.6 million identified as the Ending Amount Available for Appropriations shown on the current General Fund Five-Year Financial Forecast (Attachment A) plus approximately $9 million that was recently transferred from the Los Angeles County Auditor Controller to the City following the outcome of litigation related to the dissolution of the state's redevelopment program, along with some addition one-time revenues.

While \$30 million is significant sum of money, it's important to put it in proper context. These are one-time dollars, which represent approximately 12.5% of budgeted appropriations, and that once spent are no longer available. More importantly, although significant progress has been made in reducing the future projected gap between revenues to expenses, the Five-Year Financial Forecast currently anticipates that more than \$17 million of the \$30 million will be needed to balance the budget over the course of the next four fiscal years. As has been discussed on several occasions, unless this trend is reversed, the City will consume its unassigned fund balance, and ultimately tap into its committed contingency reserve.



Staff is proposing the following strategy as a way of addressing these fiscal challenges:

1. Maintain fiscal discipline as it relates to the General Fund Operating Budget. As discussed above, the Fiscal Year 2018 (FY18) Recommended Operating Budget as presented is fully balanced. To achieve this, in excess of \$4 million in reductions were made between FY17 and FY18. Nevertheless, current projections indicate that just under \$3 million of additional reductions or increased revenues, or some combination thereof, will be necessary to balance the FY19 Operating Budget.

Cap the General Fund Emergency Contingency Reserve at 15% of current year appropriations and create an Operating Reserve of 5%. Fully fund each of these reserves at \$35.5 million and \$11.8 million respectively. The recommendation to amend the current Fund Balance Policy and split the current 20% reserve into two portions is in recognition that the City has a large number of other obligations and liabilities that could necessitate utilizing reserved funds, but may not rise to the level of a true fiscal emergency. Moreover, from time to time there may be opportunities to further the long term interest of the City through the strategic use of reserves such as the acquisition of land. By maintaining a separate reserve the City maintains such flexibility without having to utilize funds truly intended for fiscal emergencies.

2. Establish two Section 115 Trusts to prefund pension and OPEB liabilities at $10 million and $2 million respectively. Section 115 Trusts can be used by local governments towards pre-funding pension and OPEB obligations, and offer the following benefits:

- Act as a reserve fund to help the City pay for increasing annual contribution requirements

- Provide local control and more flexibility in investment allocations compared to maintaining funds in a City-invested reserve or making additional contributions to CalPERS to pay down unfunded liability

- Allows for a higher discount rate to be used for OPEB liabilities, which in turn lowers the overall liability

- Offer higher investment returns than could be attained by maintaining monies within the City's investment portfolio (which is restricted by State regulations to fixed income instruments and has yielded a return of approximately 1.4 percent in the last year)

To date over 40 towns, cities and counties in California have established Section 115 Trusts to deal with their pension and OPEB liabilities. In the last few weeks the neighboring city of Glendale established a trust with an initial investment of $35 million and it is expected that many others will follow suit.

The chart below shows the current rates and dollars being paid to CalPERS for FY2018 along with the projections through FY2023. As indicated, the General Fund's costs are anticipated to increase by $20 million in 5 years. Assuming that CalPERS hits its assumptions on an ongoing basis, the City's annual contributions are expected to continue to rise through FY 2032 and will likely not begin declining until FY 2035.

Fiscal Year*	**Safety Rate**	**Misc. Rate**	**Citywide Cost (Normal + UAL)**	**GF Cost (Normal + UAL)**
FY 2017-18	38.09%	24.57%	$ 44,786,282	$ 25,080,318
FY 2018-19 Projected	42.96%	27.74%	$ 52,066,257	$ 29,157,104
FY 2019-20 Projected	48.03%	31.02%	$ 59,959,228	$ 33,577,168
FY 2020-21 Projected	53.87%	34.65%	$ 69,089,953	$ 38,690,374
FY 2021-22 Projected	57.49%	37.06%	$ 76,051,715	$ 42,588,960
FY 2022-23 Projected	59.46%	39.13%	$ 82,080,269	$ 45,964,950

* Based on data provided by CalPERS

Based on current projections, it is highly unlikely that growth in City revenues will be sufficient to fully offset these additional pension costs. Moreover, while shifting more pension payments to City employees would help, it would also not resolve the issue. For example, based on General Fund's current payroll of $150 million annually, an additional 3% cost sharing on the part of City employees would generate $4.5 annually, which represents an amount roughly equal to a single year's anticipated increase. Consequently, if left unaddressed the City will likely be faced with the prospect of making significant service reductions in order to free up scarce financial resources to fund pension contributions. However, by acting now to establish a Section 115 Trust and making ongoing future contributions to that Trust, the City can reduce its liabilities through prudent investments.

As stated above, one of the key benefits of a Section 115 Trust is that the funds may be invested outside of the State's regulations for the City's regular investment portfolio. It is reasonable to assume that an annual rate of return of 4 - 5% is realistic assuming stable economic conditions. For example, the HighMark Capital portfolio, which is used by Public Agency Retirement System, one of the two providers of Section 115 Trusts in California, has generated returns between 3.8% - 5.0% over the past ten years, even when accounting for the past recession. The City would have the option of using the portfolio of the Trust Administrator or could develop its own portfolio allocation based on an investment policy. Additionally, these types of trust funds seek returns similar to the market average, which is far less aggressive that what CalPERS seeks to achieve its current 7.5% target, which leads CalPERS to make higher risk investments with greater volatility.

Aside from the investment risk that the City takes with the portfolio, there is no risk to obtaining the funds should such need arise. Trust funds may be withdrawn at any time for pension or OPEB obligations, depending on the nature of the trust. Since the City's annual pension obligation is well above the amount being established by the proposed trust, these funds could be drawn down within one fiscal year if the City chose to use the trust to make all of the required CalPERS contribution in a given year. For example, if circumstances necessitated a withdrawal of money from the Trust in FY 2020, the City Council could liquidate the Trust to offset the FY 2020 General Fund portion ($33.5 million) of the CalPERS bill.

In addition to the initial contribution to the pension trust, it is also recommended that the City's Fund Balance Policy be amended to direct future one-time revenues or fiscal year-end surpluses to the Trust. While not used to balance the proposed operating budget for FY18, staff anticipates that the General Fund will receive at least $6 million in one-time revenue from the continued unwinding of redevelopment. It is recommended that most if not all of these funds be allocated to the Trust.

Should the Council proceed with this recommendation, staff would engage the services of an Actuary to further refine anticipated future pension costs and determine the optimal funding level for the Trust. Based on current information, it is expected that ideally the Trust would need $75 - $100 million to provide optimal pension rate stabilization for the General Fund.

As mentioned above, there are currently only two independent retirement plan administrators in California authorized to offer Section 115 Trusts, Public Agency Retirement System (PARS) and Public Financial Management Group (PFM). Both administrators have received a Private Letter Ruling from the Internal Revenue Service, which assures participants of the tax-exempt status of their investments. To date, the most widely adopted Section 115 Trust Program has been the plan administered by PARS. The City of Pasadena has an existing relationship with PARS for the City's part-time retirement payments in-lieu of participating in Social Security. Should the Council accept the staff recommendation, staff would request proposals from both firms to ensure the City had the best plan possible and return to Council for formal authorization.

3. Allocate $1 million of undesignated fund balance to both the Workers Compensation Fund and the General Liability Fund. While the stability of both of these funds has improved in the past two years, each remains significantly below their respective policy targets. The Workers Compensation Fund is currently funded at 11% with a policy target of 70% and the General Liability Fund stands at 14% with a policy target of 70%. An additional contribution to speed up the recovery of these two funds will help ensure that there are adequate funds available to address liabilities as they arise. Importantly, this underfunding has been noted by Fitch Ratings as a concern in their most recent review of the City and a strong statement to add additional funding will be a positive step forward.

4. Consider seeking voter approval for a revenue measure either to support needed capital projects or operations. Separately this evening the City Council will be presented potential revenue measures which could be considered in order to support of either capital improvements or ongoing operations.

Council Policy CONSIDERATION:

The City Council's strategic planning goal of maintaining fiscal responsibility and stability will be advanced by the commitment of these funds in line with existing fiscal policies.

ENVIRONMENTAL ANALYSIS:

The proposed action has been determined to be exempt from the California Environmental Quality Act ("CEQA") pursuant to State CEQA Guidelines Section 15061 (b)(3), the general rule that CEQA applies only to projects which have the potential for causing an significant effect on the environment. Where it can be seen with the certainty that there is no possibility that the activity in question may have a significant effect on the environment, the activity is not subject to CEQA. Such is the case with the proposed commitment of funds to the General Fund Emergency Contingency, which does not propose any physical changes to the environment and does not involve any commitment to any specific project.

FISCAL IMPACT:

As discussed above and during recent budget deliberations on both the Operating and Capital Budgets, the City is facing significant financial challenges in the form of current and future projected pension contributions, OPEB liabilities and the need to address significant infrastructure needs in addition to the ongoing challenges of operating a complex municipal enterprise. The prudent financial measures outlined in this report will help position the City to successfully address these challenges while continuing its mission to deliver exemplary municipal services. Moreover, such proactive steps are viewed as positive actions by the rating agencies and may prevent future credit rating downgrades of the City's General Fund.

Respectfully submitted,

Matthew E. Hawkesworth
Director of Finance

Approved by:

Steve Mermell
City Manager

SECTION 115 PENSION RATE STABILIZATION TRUST FUND

BACKGROUND

In order to strengthen the long-term sustainability of their fund, improve the funding ratio of its retirement plans and reduce the risk of volatile investment markets, the CalPERS Board of Administration has implemented numerous changes to its actuarial assumptions and methodologies. These changes follow CalPERS's portfolio loss of 24% during the last recession (2009) and an average 10-year return of just 5.03% — far below the 7.5% average annual return required by CalPERS's Board and assumed by its internal actuaries.

The most significant of these changes includes lowering CalPERS's assumed rate of return (i.e. the discount rate) to 7.0%. Lowering the discount rate means plans will see an increase in normal costs (the cost of benefits accrued by active members in the current year) and the accrued liabilities. These increases will result in higher required employer contribution rates beginning in FY 2018-19. In addition, CalPERS's recently increased the life expectancy of beneficiaries. This change has resulted in an increase to the required employer contribution rate beginning this fiscal year. As a result of these changes, and others, member agencies will see significant long-term increases in their annual required employer contribution rates.

As described by the City's independent actuary, John Bartel (Bartel Associates), employer costs as a percent of payroll for Glendale are expected to rise substantially and not return to current levels for another twenty-five to thirty years. After a steady, prolonged increase from current rates, the City's required contribution rates for public safety employees could potentially peak at 77% of PERS-able wages in 2031; for miscellaneous employees, rates may peak at 46% during the same year. As a comparison, current FY 2016-17 rates are 42% for public safety employees and 23% for miscellaneous employees.

During this period of prolonged rates increases the City is expected to make substantial progress in paying down its unfunded actuarial liability (UAL). Bartel Associates projects that the retirement plan for miscellaneous employees could be fully funded as soon as FY 2026-27 (currently estimated at 74% funded), and the plan for safety employees could be fully funded as soon as FY 2031-32 (currently estimated to at 67% funded).

What can the City do to mitigate rising costs?

While the City has built these projected rate increases into its five-year General Fund forecast, more still needs to be done to prepare the City for these long-term cost increases. One option recommended by City staff and the City's independent actuary, Bartel Associates, is to establish an IRC Section 115 Trust for pension obligations. A Section 115 Trust is a tax-exempt investment tool used to prefund essential government expenses (i.e. retiree medical or retirement plan benefits). Because trust assets are designated for essential government expenses, they are exempt from the state mandated investment restrictions places on the City's internally managed portfolio. As such, they can be used to purchase mutual funds or bonds with mid- to long-term horizons and higher returns.

Funds placed in a Section 115 Trust can remain in the trust until a point in time when the contributing agency (i.e. the City) chooses to drawdown its assets to pay annual benefit obligations. Rather than withdrawing funds, trust managers are also able to accommodate requests from the City to reallocate funds from moderate risk investments to conservative investments in an effort to, at a moment's notice, reduce risk exposure and stem losses. City's opting for an actively managed portfolio receive, for an additional fee, investment managers who actively monitor the portfolio and can make such adjustments as they deem necessary.

With respect to looming cost increases for the City's retirement plans, contributions held in an IRC Section 115 Trust can be withdrawn at any time to mitigate CalPERS rate impacts to the General Fund. Though the City can withdrawal funds from the trust at any time, the annual withdrawal amount could not exceed and amount equal to two years' pension costs.

In order to remain tax-exempt, assets held in IRC Section 115 Trust are designated as irrevocable, meaning they must be used to fund the City's retirement plan obligations. For this reason, withdrawals from a trust may be made to either reimburse the City for current and/or previous year's payments, or to pay CalPERS directly.

ANALYSIS

Through the deposit of funds into an IRC Section 115 Trust, the City Council could expect to earn a long-term rate of return greater than what would be attained through the City's investment pool managed by the City Treasurer. This higher return is made possible because IRC Section 115 Trusts are not prohibited by state law from making purchases of higher yielding equities or long-term fixed-income assets, such as bonds. Trust assets can therefore be expected to accumulate through earned dividends, interest income and capital appreciation (the sale price of an investment compared to its lower purchase price).

Though the City could undergo the process of establishing its own IRC Section 115 Trust, this process would take one to two years and would require considerable resources in the form of staff time and attorney's fees to ensure continued compliance with all applicable federal and state laws. As an alternative, Finance staff explored the feasibility of participating in an established, multiple employer IRC Section 115 Trust, also known as a "Pension Rate Stabilization Program" (PRSP). Through the adoption of such a program, the City would benefit from streamlined legal, administrative and reporting services provided by the Trust Administrator. In addition, PRSPs provide dedicated portfolio management and financial planning services through experienced third-party investment firms.

Returns on trust fund portfolios managed through PRSPs vary due to different levels of risk tolerance and asset mixes among PRSP clients. However, 12-month returns for 1st Quarter 2017 range from 4.07% to 13.08%. As a comparison, the average 12-month return for the City's investment pool was 0.78% as of 1st Quarter 2017. In this instance, a trust portfolio returning 5.0% would have earned 6.4 times as much as the City's portfolio.

Benefits of a Pension Rate Stabilization Program

Participation in a PRSP provides the City with numerous benefits, such as:

- **Pension Rate Stabilization** – Over recent years, CalPERS's highly aggressive investment strategy has underperformed, resulting in lower than anticipated earnings (e.g. 0.6% for 2016 rather than the targeted 7.5%) and higher contribution rates for member cities. Hence, any additional payments issued to CalPERS above the annual required contribution may not have an impact on the City's future contribution rates. Alternatively, trust assets managed by PRSPs are invested responsibly and can be accessed at the City's discretion to offset costs resulting from peak contribution rates (rate stabilization), thereby maximizing savings to the General Fund.

- **Return on Taxpayer Investment** – Assuming assets earn a conservative average return of 5.0% (net of fees) over the life of the trust (approximately 20 years), and that the City's total deposit is $35 million by FY19-20, the trust portfolio is estimated to return $1.8 million to the taxpayer for every $1.0 million deposited. If average returns are 6.0% (net of fees) the portfolio is estimated to return $2.0 million for every $1.0 million deposited.

- **City Control Over Assets** – CalPERS invests local agency assets without respect to the agency's risk tolerance. An IRC Section 115 Trust provides an alternative means for prefunding retirement plan obligations, and allows agencies to invest based on their unique level of risk tolerance.

- **Diversified Investments/Potential for Greater Returns** – Investment restrictions which apply to local agency general funds (CA Govt. Code Sec. 53601) are not applicable to local agency assets held in an IRC Section 115 Trust (CA Govt. Code Sec. 53216), providing portfolio managers the ability to invest in multiple asset types and diversity risk.

- **Rainy Day Fund** – A PRSP would provide the City with the flexibility it needs to manage operations in an emergency situation. For example, withdrawals from the trust can be made at any time to alleviate the General Fund of a significant financial burden caused by either a drop in revenue or a natural disaster. Under the rules of the trust, withdrawn funds would be sent to CalPERS, freeing up an equal amount in that year's budgeted appropriations.

- **Trust Assets are Secure** – PRSP assets are held in a "walled-off" trust by a Discretionary Trustee/custodian (e.g. a bank or trust), meaning they are insulated from creditors.

- **Oversight of Funds** – PRSPs allows members to select their own risk tolerance level and maintain oversight of performance while giving discretionary investment control to the portfolio manager for individual fund selection.

<u>Pension Rate Stabilization Program (PRSP) Evaluation Process</u>

Finance Department staff identified and assessed multiple firms (i.e. trust administrators) that offer local agencies the opportunity to participate in multiple-employer IRC Section 115 Trusts for pensions, also known as Pension Rate Stabilization Programs (PRSPs). Staff received information regarding investments and fee proposals from firms and evaluated their programs based on the following criteria: years of experience, number of clients, historical returns, flexibility of investments, fees, and tax exempt status as established through an IRS private letter ruling (PLR).

Based on the above criteria staff respectfully recommends PARS as the City's trust administrator, for the following reasons:

- PARS, a retirement services provider, has thirty-two years of business experience and is a recognized industry leader for public employee benefit services. PARS currently has 84 members participating in its Pension Rate Stabilization Program, the most of any known provider. PARS's clients are comprised of cities (36), counties (8), special districts (15) and education districts (25).

- PARS offers investment services through HighMark Capital, an investment management firm which offers five diversified portfolios for PARS clients with long-term, mid-term and short-term investment horizons. Highmark's Moderate portfolio has a 12-month average gross return of 9.67%, and a five-year average gross return of 6.34%. PARS is partnered with U.S. Bank, the trustee and plan fiduciary responsible for safeguarding member assets.

Under the terms of the trust, U.S. Bank provides legal oversight and holds member assets in a "walled-off" trust which protects assets from creditors.

- PARS's fee structure is comparable to that of other providers and, like other providers, is tiered and calculated as a percentage of trust assets – the fee structure is arranged so that fees decline as assets increase. Staff estimates that for the next seven year period, annual fees would range between 0.55% to 0.38% of assets, with the lower fee representing a higher balance. Fees are deducted from trust assets on a monthly basis and itemized for services provided by the Trust Administrator (PARS), the Discretionary Trustee (U.S. Bank) and the Investment Manager (HighMark Capital).

- Of the three firms evaluated, PARS is one of only two firms to have received a favorable PLR from the IRS for its Pension Rate Stabilization Program, establishing that their trust can operate on a tax-exempt status.

For the above reasons, Finance Department staff respectfully requests that the City Council adopt the attached resolution to authorize participation in the PARS Pension Rate Stabilization Program Section 115 Trust and appoint the City Manager as the City's Plan Administrator. Additionally, it is recommended that the City Council approve the attached motions authorizing the City Manager to execute a professional services agreement with PARS for trust administration services, and authorizing the City Manager to execute all necessary documents with U.S. Bank, the Discretionary Trustee, and HighMark Capital, the Investment Manager.

No deposit to the trust will be made at this time. Any potential amount will be decided on by the City Council at a future date.

FISCAL IMPACT

The table below depicts the total City appropriations by fund type as adopted for FY 2016-17 and as proposed for FY 2017-18.

Total Appropriations

Fund Type	Proposed 2016-17	Proposed 2017-18	Increase/ (Decrease)	% Change
General Fund	$ 194,780,663	$ 215,042,945	$ 20,262,282	10.4%
Special Revenue	100,630,978	98,780,317	(1,850,661)	-1.8%
Debt Service	3,010,000	2,222,150	(787,850)	-26.2%
Capital Projects	25,362,000	16,008,821	(9,353,179)	-36.9%
Enterprise	385,917,075	393,568,677	7,651,602	2.0%
Internal Service	109,832,418	111,291,567	1,459,149	1.3%
Totals	**$ 819,533,134**	**$ 836,914,477**	**$ 17,381,343**	**2.1%**

A summary of appropriations and revenue estimates for all funds can be found at Attachments 1 and 2 respectively.

There is no fiscal impact related to establishing the Section 115 Trust Fund without an initial deposit. If it pleases the City Council, staff will return at a future date to report on the fiscal impacts of any potential deposit amounts.

ALTERNATIVES

Alternative 1: It is recommended that the City Council approve the attached resolutions adopting the City of Glendale FY 2017-18 Budget, the Citywide Fee Schedule and fee increases, adjustments to the classification and compensation schedules, establishing Section 115 Pension Rate Stabilization Trust Fund; and the attached motions authorizing the City Manager, or his designee to award a Professional Services Agreement to Public Agency Retirement Services for participation in a Pension Rate Stabilization Program (the "Program") and to execute all necessary documents with U.S. Bank for Discretionary Trustee services and HighMark Capital for Investment Management services.

Alternative 2: The City Council may consider any other alternative not proposed by staff.

CAMPAIGN DISCLOSURE

Not applicable.

ATTACHMENTS

Attachment 1: Summary of Appropriation by Fund Type
Attachment 2: Summary of Revenues by Fund Type
Attachment 3: FY 2017-18 Proposed Citywide Fee Schedule
Attachment 4: Salary Listings "Exhibit A" effective 7/01/2017
Attachment 5: IRS Private Letter Ruling – PARS Pension Rate Stabilization Program (PRSP)
Attachment 6: PARS Professional Service Agreement (DRAFT)
Attachment 7: US Bank Discretionary Trustee Forms (DRAFT)