Is Your City Really Prepared for Rising Pension Costs?

October 7, 2020
Introductions

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Senior Municipal Consultant

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Government Finance Consultant

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The Crisis: What We’re Facing

“If you find yourself in a hole, stop digging.”

Will Rogers

Uncertainty

Rising Pension Costs

Investment/Market Fluctuation

Competing Budget Priorities

“Figuring it out” Too Late
What is an Unfunded Liability?
Rate Volatility!

Achieve to Assumptions

- Discount Rate
- Amortization period
- Wage Growth
- Longevity
- Inflation
- Payroll Growth
- Demographic (mortality, etc.)

Actual Experience

- Investment Returns
- Wage Growth
- Payroll Growth
Discount Rate

[Graph showing the discount rate from 1950 to 2000. The graph compares the 10-Year Treasury and CalPERS Assumed Rate of Return.]
Actual Investment Returns vs. Current Assumed Discount Rate
Looking Forward

• One-time event
  • How does this year’s return affect UAL and contributions?

• FY 2020 as the New Normal
  • What if your pension system continues to get a 4.7% rate of return?
  • What if your pension system lowers the discount rate even further?
One-Time Event

4.7% Return in 2019, 7% Return Onwards
New Normal

Continue 1-Year Average Return (4.7%)
What Cities Can Do Today

Many cities have already exercised their limited options under current law to address the fiscal challenges attributed to growing pension liabilities, which include:

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. This option may only work for cities in a better financial condition.

2. **Consider local ballot measures to enhance revenues:** Some cities have been successful in passing a measure to increase revenues. Others have been unsuccessful. Given that these are voter approved measures, success varies depending on location.

3. **Create a Pension Rate Stabilization Program (PRSP):** Establishing and funding a local Section 115 Trust Fund can help offset unanticipated spikes in employer contributions. Initial funds still must be identified. Again, this is an option that may work for cities that are in a better financial condition.

4. **Change service delivery methods and levels of certain public services:** Many cities have already consolidated and cut local services during the Great Recession and have not been able to restore those service levels. Often, revenue growth from the improved economy has been absorbed by pension costs. The next round of service cuts will be even harder.

5. **Use procedures and transparent bargaining to increase employee pension contributions:** Many local agencies and their employee organizations have already entered into such agreements.

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.
What Are Section 115 Pension Prefunding Trusts?

• Section 115 Trusts can be used by local governments to fund essential government functions (i.e., retiree healthcare, pension)

• In 2015, GASB 68 required disclosing the Net Pension Liability as a line item on the balance sheet

• In 2015, the nation’s first Section 115 Combination Trust (to prefund both pension and OPEB) was established and received the first IRS Private Letter Ruling (PLR) on multiple employer basis

• A PLR ensures tax qualified status whereby any income derived is tax exempt
How Can a 115 Trust Be Structured?

Subaccounts
OPEB and pension assets are individually sub-accounted, & can be divided by dept., bargaining group, or cost center

Anytime Access
Trust funds are available anytime; OPEB for OPEB and pension for pension.

Financial Stability
Assets in the Section 115 Combination Trust can be used to address unfunded liabilities.

Flexible Investing
Allows separate investment strategies for all OPEB and pension subaccounts.
Why Prefund Pension Obligations?

<table>
<thead>
<tr>
<th></th>
<th>Stabilize Costs</th>
<th>Local Control</th>
<th>Protection</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Access funds to reimburse your City for pension-related expenses to help offset rising pension contribution rates</td>
<td>City maintains autonomy over assets, contributions, disbursements, timing and investment risk tolerance</td>
<td>Funds in the trust are securely set-aside and protected from diversion for uses other than pension</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Diversified Investing</th>
<th>Rainy Day Fund</th>
<th>Long-Term Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>Assets in an exclusive benefit trust can be diversely invested and may achieve greater returns than your general fund/treasury pool</td>
<td>Emergency source of funds when employer revenues are strained in difficult budgetary or economic times</td>
<td>Prudent solution for managing ongoing pension liabilities on financial statements due to GASB 68</td>
</tr>
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</table>
Why Use a 115 Trust vs. Reserve Account?

<table>
<thead>
<tr>
<th>Reserve Account</th>
<th>115 Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed income investing only</td>
<td>Fixed Income or diversified investing available</td>
</tr>
<tr>
<td>Investments not tailored for long term</td>
<td>Can be tailored for short or long term</td>
</tr>
<tr>
<td>Conservative returns</td>
<td>Opportunity to earn a greater rate of return</td>
</tr>
<tr>
<td>Revocable</td>
<td>Irrevocable (for pension expenses)</td>
</tr>
<tr>
<td>Can be accessed for other uses</td>
<td>Dedicated solely for pension costs</td>
</tr>
<tr>
<td>Unprotected from creditors</td>
<td>Exclusive benefit/protected from creditors</td>
</tr>
<tr>
<td>No corporate trustee</td>
<td>Corporate trustee to mitigate fiduciary risk</td>
</tr>
</tbody>
</table>
Investment Flexibility

- Agency maintains oversight of the investment manager and the portfolio’s risk tolerance level
- Investment restrictions that apply to the general fund (CA Government Code 53601) are not applicable to assets held in Section 115 Irrevocable Trust
- Assets held in Section 115 Irrevocable Trust can be invested per Government Code Sections 53216 (Pension) and 53620 (OPEB)
- Investments can be diversified and invested in a prudent fashion
- Investments can be tailored to the Agency’s unique demographics and needs
- Increased risk diversification

Diversified Investing
Assets held in Section 115 Irrevocable Trust can be diversely invested in a prudent fashion per Government Code Sections 53216 (Pension) and 53620 (OPEB).

GOV § 53216 (Pension)
GOV § 53620 (OPEB)
Determine Strategic Allocation Strategy

Efficient frontier of portfolios with varying ranges of equities and fixed income

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Equity</th>
<th>Fixed Income</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservative</td>
<td>5-20%</td>
<td>60-95%</td>
<td>0-20%</td>
</tr>
<tr>
<td>Moderately Conservative</td>
<td>20-40%</td>
<td>50-80%</td>
<td>0-20%</td>
</tr>
<tr>
<td>Moderate</td>
<td>40-60%</td>
<td>40-60%</td>
<td>0-20%</td>
</tr>
<tr>
<td>Balanced</td>
<td>50-70%</td>
<td>30-50%</td>
<td>0-20%</td>
</tr>
<tr>
<td>Capital Appreciation</td>
<td>65-85%</td>
<td>10-30%</td>
<td>0-20%</td>
</tr>
</tbody>
</table>
Sample Portfolio Returns

**ACTIVE PORTFOLIO RETURNS**

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Equity (%)</th>
<th>1 Year</th>
<th>3 Years</th>
<th>5 Years</th>
<th>10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Appreciation</td>
<td>65-85%</td>
<td>2.66%</td>
<td>6.26%</td>
<td>6.42%</td>
<td>9.06%</td>
</tr>
<tr>
<td>Balanced</td>
<td>50-70%</td>
<td>3.51%</td>
<td>6.07%</td>
<td>6.01%</td>
<td>8.24%</td>
</tr>
<tr>
<td>Moderate</td>
<td>40-60%</td>
<td>3.96%</td>
<td>5.77%</td>
<td>5.67%</td>
<td>7.48%</td>
</tr>
<tr>
<td>Moderately Conservative</td>
<td>20-40%</td>
<td>4.87%</td>
<td>5.22%</td>
<td>4.90%</td>
<td>5.97%</td>
</tr>
<tr>
<td>Conservative</td>
<td>5-20%</td>
<td>5.78%</td>
<td>4.93%</td>
<td>4.41%</td>
<td>4.75%</td>
</tr>
</tbody>
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As of June 30, 2020
What Investment Options Are Typically Used?

- Conservative: 4.17%
- Moderately Conservative: 38.89%
- Moderate: 31.94%
- Balanced: 15.28%
- Capital Appreciation: 8.33%
- Other: 0%
# Sample Funding Policies

<table>
<thead>
<tr>
<th></th>
<th>Contribution Policy</th>
<th>City</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Contribute 50% of a given year’s realized year end surplus to address pension liability</td>
<td>Alameda/Solana Beach</td>
</tr>
<tr>
<td>2</td>
<td>Contribute full amount of annual pension employer cont., allowing anytime access to trust assets</td>
<td>City of Brea</td>
</tr>
<tr>
<td>3</td>
<td>Contribute funds to stabilize pension system employer Misc. and Safety rates through FY 23-24</td>
<td>City of Healdsburg</td>
</tr>
<tr>
<td>4</td>
<td>“One equals five plan” - $1M contribution for 5 years will save taxpayers $5M over 25 years</td>
<td>City of Huntington Beach</td>
</tr>
<tr>
<td>5</td>
<td>Contribute Employer contribution equal to the 2.8% discount rate, with difference going into the Section 115 Trust</td>
<td>City of Sausalito</td>
</tr>
<tr>
<td>6</td>
<td>Maintain a 15% general fund reserve and target add ‘l cont. over and above that threshold</td>
<td>City of Redwood City</td>
</tr>
<tr>
<td>7</td>
<td>Earmark a portion of a local sales tax to be set aside for unfunded pension liabilities</td>
<td>City of Fountain Valley</td>
</tr>
<tr>
<td>8</td>
<td>Use ongoing savings from prepaying pension system unfunded liability vs. higher monthly payments</td>
<td>City of Pasadena</td>
</tr>
<tr>
<td>9</td>
<td>Use one-time revenue source and lower the minimum General Fund Reserve level (30% → 20%)</td>
<td>City of Glendale</td>
</tr>
</tbody>
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Pension Funding Policy Elements

- Funding goal
- Timeframe
- Funding components
- Allowable Uses of Funding
- Service Delivery Outcomes
- Fiscal Impacts

![Table 2: Pension Funding Policy Examples](image-url)

*This information is not available at the time of the printing of the report; however, staff is working to provide a metric for context.
Questions?

Please reach out to panel with any questions:

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