The Road Ahead for Managing Rising Pension Costs
Thursday, September 23, 2021 | 2:45 - 4:00pm
July 2021
Introductions

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Senior Municipal Consultant

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Town of Yountville

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Former Finance Director
Government Finance Consultant

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Senior Manager, Consulting
PARS | Public Agency Retirement Services
What We’re Facing

- 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
Challenge in Achieving to Assumptions
21.3% Investment Return

10-year Annualized Rate of Return 8.5%
Looking Forward

Funding Risk Mitigation Policy = 6.8%

<table>
<thead>
<tr>
<th>Excess Investment Return</th>
<th>Reduction in Discount Rate</th>
<th>Reduction in Expected Investment Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>If the actual investment returns exceed the discount rate by:</td>
<td>Then the discount rate will be reduced by:</td>
<td>And the expected investment return will be reduced by:</td>
</tr>
<tr>
<td>2.00%</td>
<td>0.05%</td>
<td>0.05%</td>
</tr>
<tr>
<td>7.00%</td>
<td>0.10%</td>
<td>0.10%</td>
</tr>
<tr>
<td>10.00%</td>
<td>0.15%</td>
<td>0.15%</td>
</tr>
<tr>
<td>13.00%</td>
<td>0.20%</td>
<td>0.20%</td>
</tr>
<tr>
<td>17.00%</td>
<td>0.25%</td>
<td>0.25%</td>
</tr>
</tbody>
</table>
Looking Forward

Potential Impact to Total Required Employer Contributions
(21.3% Return, Discount Rate Assumptions: 7% through 6%)

20 Year Impact to Required Contributions
Net of 21.3% Investment Return Experience
Looking Forward

Approximate Increase to Normal Cost from Current 7% Discount Rate to New Assumed Discount Rate Alternatives

- Default (current): $610.86K
- 21.3% IR 6.8% DR: $648.34K
- 21.3% IR 6.5% DR: $708.34K
- 21.3% IR 6.25% DR: $762.07K
- 21.3% IR 6.0% DR: $819.47K

Graph showing the increase in total normal cost, employee contributions, and employer normal cost from fiscal year 20-21 to 2045-46.
Looking Forward

If no action is taken...

- **Total Employer Required Contribution**
- **Annual Amortization Payment**
- **Employer Normal Cost**
- **Employee Contribution**

**Default (current)**

$21.01M

7% Discount Rate, 6% Investment Return Experience (Ongoing)

- $21.01M
- No change
Looking Forward

If no action is taken…

(Status Quo: 7% Discount Rate & 7% Investment Experience)
What Can Be Done?

Options for Funding CalPERS

01 Make Additional Discretionary Payment
02 Prefund into a Contingency Reserve Fund
03 Issue Pension Obligation Bonds/Certificates of Participation
04 Prefund into an IRS Section 115 Pension Prefunding Trust
05 Use Above In Combination with Each Other
Using Trust with POBs/COPs

City General Fund

Annual Debt Service

Annual Pension Payment

Section 115 Trust Account

Bond Holders

Required Payment

CalPERS

Bond Proceeds/Investment Earnings

Required Payment

$
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

**Flexible Investing**
Allows separate investment strategies for all OPEB and pension subaccounts.

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

**Financial Stability**
Assets can be used to address unfunded liabilities
Why Prefund Pension Obligations?

01  Stabilize Costs
Access funds to reimburse your City for pension-related expenses to help offset rising pension contribution rates

02  Local Control
City maintains autonomy over assets, contributions, disbursements, timing and investment risk tolerance

03  Protection
Funds in the trust are securely set-aside and protected from diversion for uses other than pension

04  Diversified Investing
Assets in an exclusive benefit trust can be diversely invested and may achieve greater returns than your general fund/treasury pool

05  Rainy Day Fund
Emergency source of funds when employer revenues are strained in difficult budgetary or economic times

06  Long-Term Planning
Prudent solution for managing ongoing pension liabilities on financial statements due to GASB 68
## 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>Revocable</td>
<td>Irrevocable (for non-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)
## Sample Portfolio Returns (as of 6/30/21)

<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>32.31%</td>
<td>13.14%</td>
<td>12.64%</td>
<td>9.75%</td>
</tr>
<tr>
<td>Balanced</td>
<td>50-70%</td>
<td>27.05%</td>
<td>11.93%</td>
<td>11.26%</td>
<td>8.67%</td>
</tr>
<tr>
<td>Moderate</td>
<td>40-60%</td>
<td>22.58%</td>
<td>10.87%</td>
<td>9.90%</td>
<td>7.81%</td>
</tr>
<tr>
<td>Moderately Conservative</td>
<td>20-40%</td>
<td>14.19%</td>
<td>8.62%</td>
<td>7.25%</td>
<td>6.01%</td>
</tr>
<tr>
<td>Conservative</td>
<td>5-20%</td>
<td>8.00%</td>
<td>6.99%</td>
<td>5.32%</td>
<td>4.63%</td>
</tr>
</tbody>
</table>
# Investment Selection Choice

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Allocation (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Appreciation</td>
<td>5.50%</td>
</tr>
<tr>
<td>(65-85% Equity)</td>
<td></td>
</tr>
<tr>
<td>Balanced</td>
<td>10.00%</td>
</tr>
<tr>
<td>(50-70% Equity)</td>
<td></td>
</tr>
<tr>
<td>Moderate</td>
<td>37.00%</td>
</tr>
<tr>
<td>(40-60% Equity)</td>
<td></td>
</tr>
<tr>
<td>Mod. Conservative</td>
<td>33.00%</td>
</tr>
<tr>
<td>(20-40% Equity)</td>
<td></td>
</tr>
<tr>
<td>Conservative</td>
<td>7.00%</td>
</tr>
<tr>
<td>(5-20% Equity)</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>7.50%</td>
</tr>
<tr>
<td>(Custom)</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>100.00%</strong></td>
</tr>
</tbody>
</table>

![Pie chart showing investment allocation](image-url)
## Sample Funding Policies

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>City</th>
</tr>
</thead>
<tbody>
<tr>
<td>01</td>
<td>Contribute 50% of a given year’s realized year end surplus to address pension liability</td>
<td><strong>Alameda/Solana Beach</strong></td>
</tr>
<tr>
<td>02</td>
<td>Contribute full amount of annual PERS employer cont., allowing anytime access to trust assets</td>
<td><strong>City of Brea</strong></td>
</tr>
<tr>
<td>03</td>
<td>Contribute funds to stabilize PERS employer Misc. and Safety rates through FY 23-24</td>
<td><strong>City of Healdsburg</strong></td>
</tr>
<tr>
<td>04</td>
<td>“One equals five plan” - $1M contribution for 5 years will save taxpayers $5M over 25 years</td>
<td><strong>City of Huntington Beach</strong></td>
</tr>
<tr>
<td>05</td>
<td>Contribute Employer contribution equal to the 2.8% discount rate, with difference going into the Section 115 Trust</td>
<td><strong>City of Sausalito</strong></td>
</tr>
<tr>
<td>06</td>
<td>Contribute the annual savings realized from Reduction in UAL payment resulting from Pension Obligation Bonds issuance</td>
<td><strong>City of Placentia</strong></td>
</tr>
<tr>
<td>07</td>
<td>Earmark a portion of a local sales tax to be set aside for unfunded pension liabilities</td>
<td><strong>City of Fountain Valley</strong></td>
</tr>
<tr>
<td>08</td>
<td>Use ongoing savings from prepaying CalPERS unfunded liability vs. higher monthly payments</td>
<td><strong>City of Pasadena</strong></td>
</tr>
<tr>
<td>09</td>
<td>Use one-time revenue source and lower the minimum General Fund Reserve level (30% → 20%)</td>
<td><strong>City of Glendale</strong></td>
</tr>
</tbody>
</table>
A Case Study: Town of Yountville
Managing Rising Pension Costs
A Unique Small Town

Located in Napa Valley

- Less than one square mile
- World class restaurants, premium hotels
- Home to the historic Veterans Home of California
- Population of 2,966 (includes Veterans Home)
- Median age: 64 years

$17M Total Expenditure Budget

- Top three General Fund revenues:
  - Transient Occupancy Tax (52%)
  - Property Tax (21%)
  - Sales Tax (12%)
- Staff of 31 full-time employees
- Contract with Napa County for law enforcement and fire protection services.
Proactive Approach to Managing Future OPEB & Pension Costs

- **OPEB** IRS Section 115 Irrevocable Trust established by Town Council Resolution in June 2011.
  
  - Initial contributions were discretionary based on available Unassigned Fund Balance in the GF at fiscal year end.
  
  - In December 2011 Town Council adopted percentage of full-time salary funding policy:
    - Fiscal Year 2012/13: 8%
    - Fiscal Year 2013/14: 9%
    - Fiscal Year 2014/15: 10%

- **Pension Rate Stabilization Plan (PRSP)** Section 115 Trust established by Town Council Resolution in December 2017.
  
  - All contributions have been discretionary based on available Unassigned Fund Balance in the GF at fiscal year end.

  - Discretionary contributions to both trusts were suspended in the third quarter of Fiscal Year 2019/2020 to help mitigate COVID-19 related revenue losses.
Trust Utilization

**OPEB Trust**
- First use in FY 2020/2021 to reimburse Town for Monthly Retiree Health Premiums
  — $138,000
- Continued use beginning in FY 2021/2022
  — $115,000

**PRSP Trust**
- First use in Fiscal Year 2020/2021 to reimburse Town for annual Unfunded Actuarial Accrued Liability payment to CalPERS
  — $276,080
- Continued use beginning in FY 2021/2022
  — $324,536
Going Forward

- Discretionary contributions into the trust could be presented to the Town Council as a suggested use for any Unassigned Fund Balance in the General Fund after the close of Fiscal Year 2020/2021.

- Contributions to the OPEB trust could potentially resume in Fiscal Year 2022/2023 at a reduced rate of approximately 7% of full-time salaries rather than the previous 14.5%.

- Similarly, contributions to the PRSP trust could also potentially resume in Fiscal Year 2022/2023 as available fund balance allows.
Preparing for the Future: How Does the Town Respond to a Potential Emergency?

- **Assigned for Budget Contingencies**
  (Reserve set at $438,386)

- **Assigned for Legal Contingencies**
  (Reserve set at $200,000)

- **Revenue Stabilization**
  Policy: Minimum funding target is 25% of TOT revenue.
  (Reserve Fund Balance $2,045,748)

- **Emergency Reserve**
  Policy is 20% of General Fund Operating Expenditures; proposed budget meets minimum
  (Reserve Fund Balance $2,045,748)
Preparring for the Future

**Retiree Health**

- Retiree Health Insurance ($115,000)
- OPEB Trust (Balance as of July 31, 2021: $5,710,535)
- Discretionary contribution to the OPEB Trust Fund (Suspended for one more fiscal year)

**Pension**

- UAAL Payment to PERS $324,526
- Pension Stabilization Rate Fund (PRSP) (Balance as of July 31, 2021: $2,580.118)
- Discretionary Contribution to PSRP Trust Fund (Suspended for one more fiscal year)
Questions?

I THINK WE'RE THE ONES WHO ARE GOING TO NEED A STRESS TEST!!!
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