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# Is Your City Really Prepared for Rising Pension Costs?

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# Introductions

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# The Crisis: What We're Facing

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

*Will Rogers*



**Uncertainty**

**Investment/Market Fluctuation**

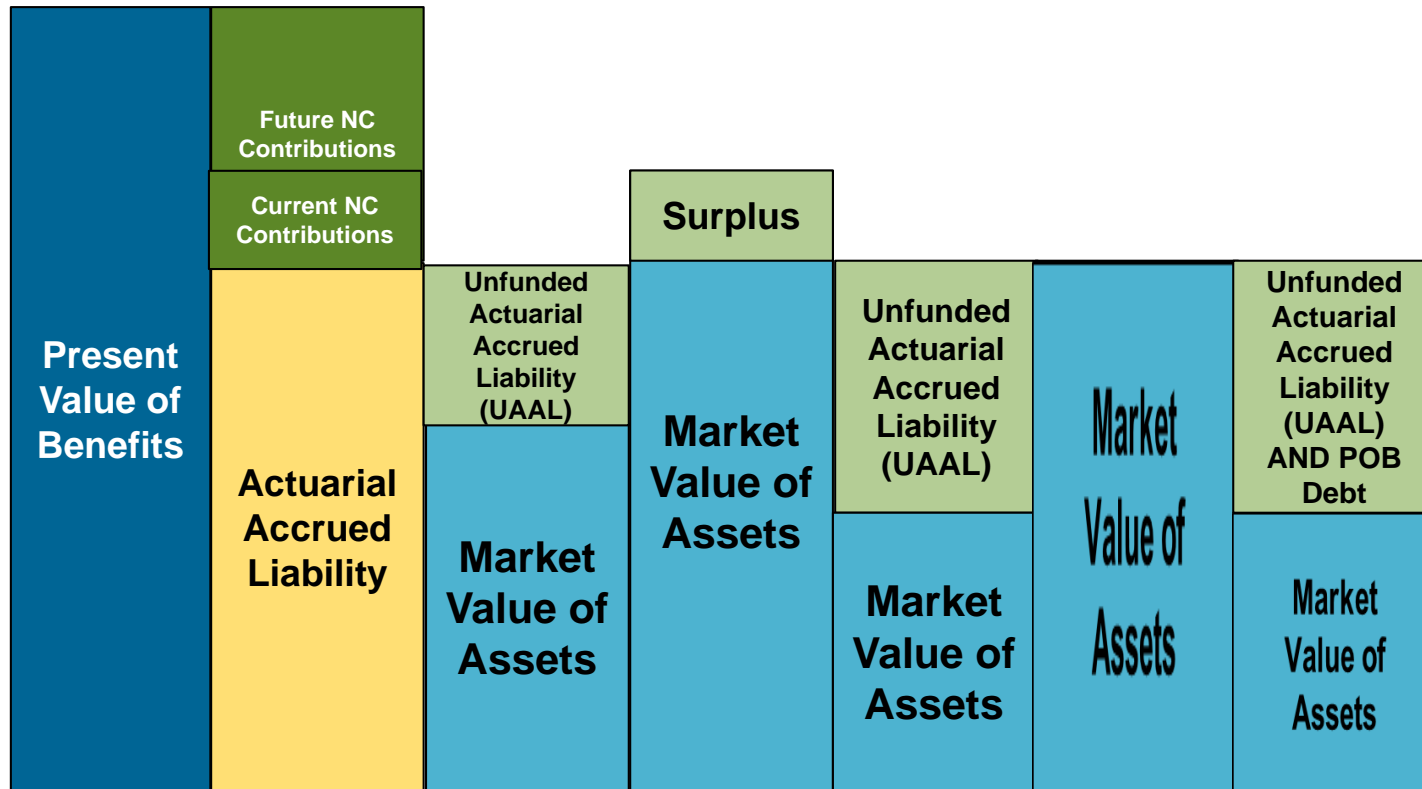
**Rising Pension Costs**

**Competing Budget Priorities**

**“Figuring it out” Too Late**

# What is an Unfunded Liability?

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# Rate Volatility!

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## Achieve to Assumptions

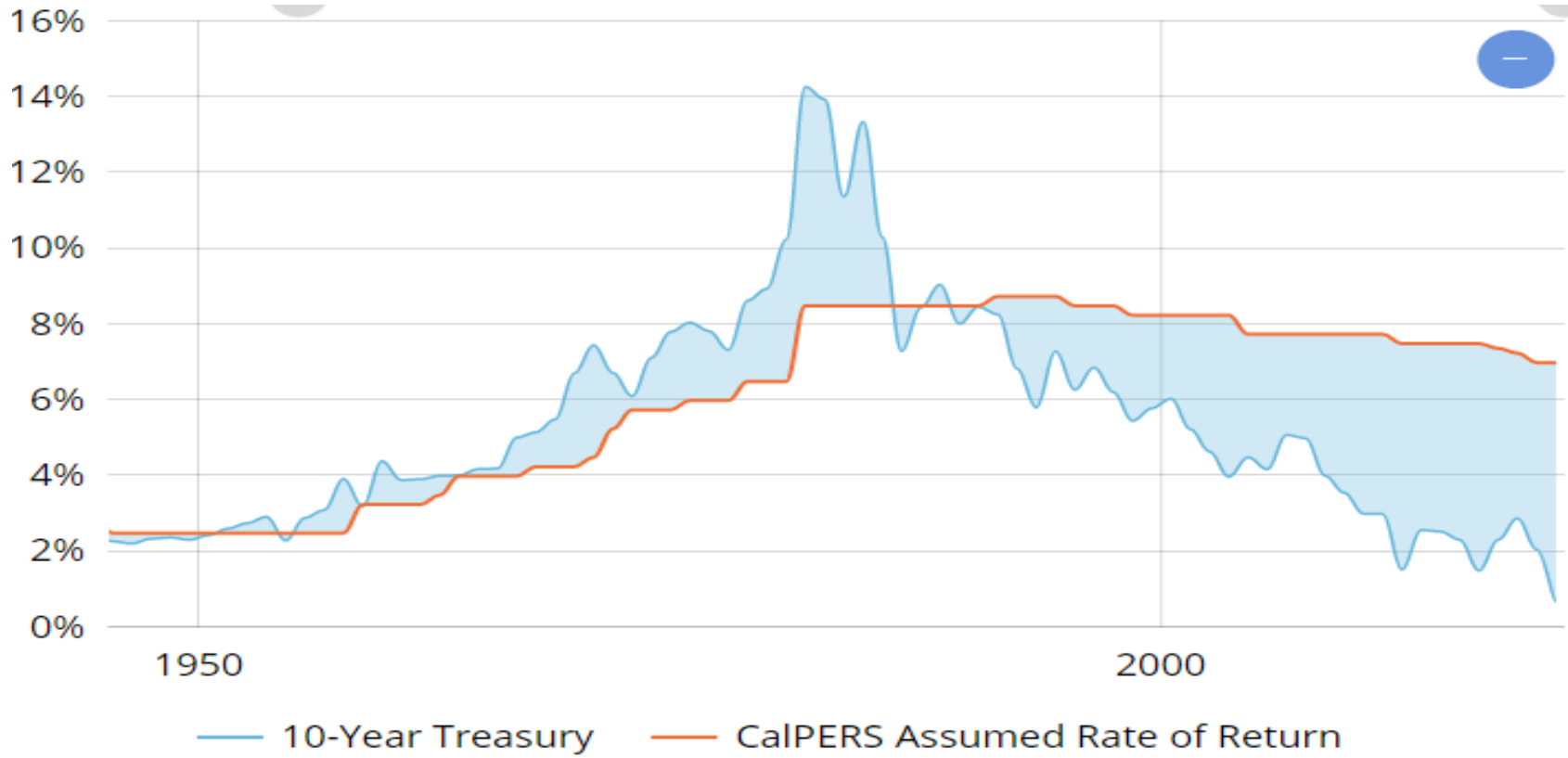
- Discount Rate
- Amortization period
- Wage Growth
- Longevity
- Inflation
- Payroll Growth
- Demographic (mortality, etc.)

## Actual Experience

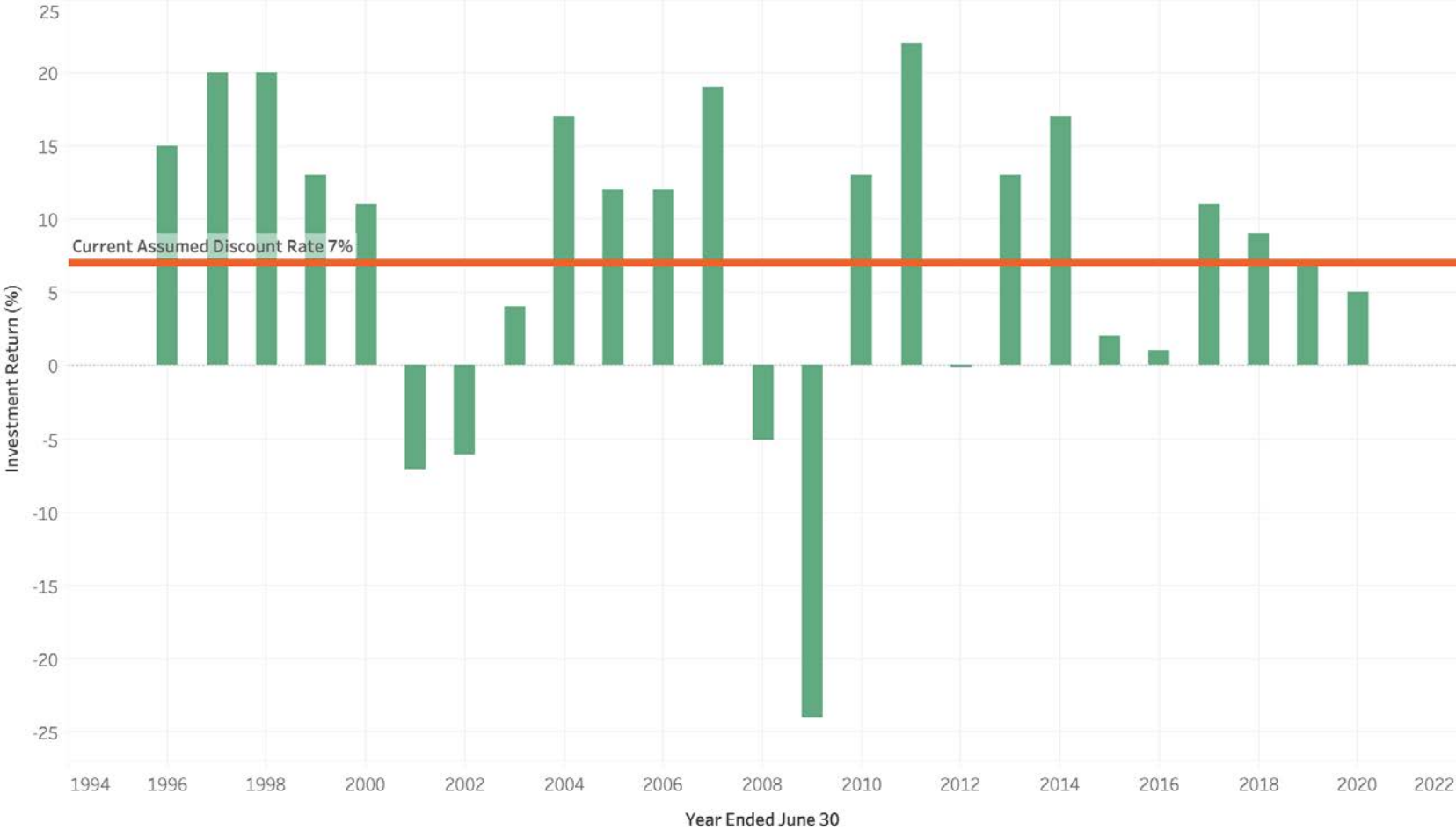
- Investment Returns
- Wage Growth
- Payroll Growth

# Discount Rate

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# Actual Investment Returns vs. Current Assumed Discount Rate



# Looking Forward

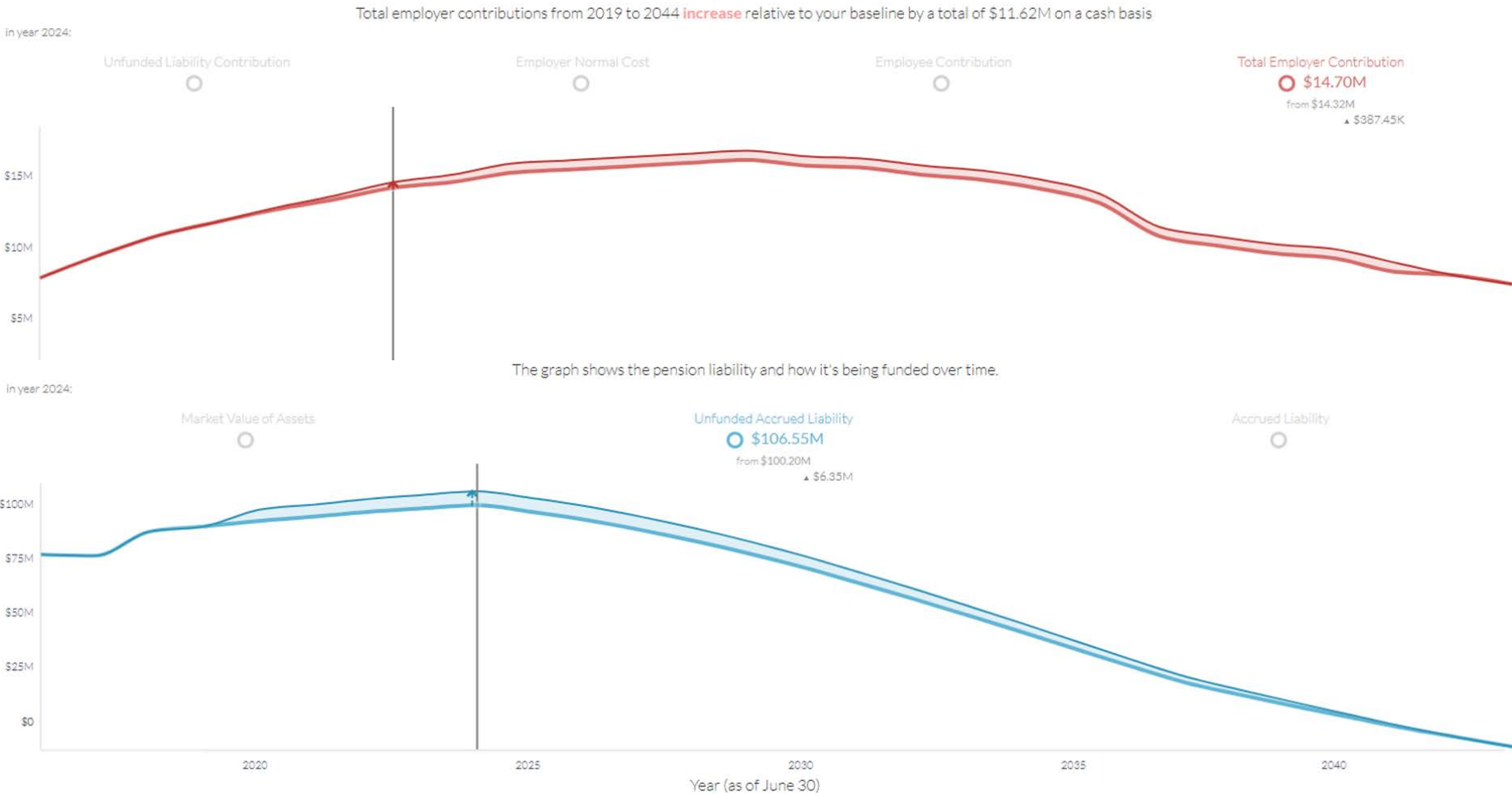
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- **One-time event**
  - How does this year's return affect UAL and contributions?
- **FY 2020 as the New Normal**
  - What if your pension system continues to get a 4.7% rate of return?
  - What if your pension system lowers the discount rate even further?



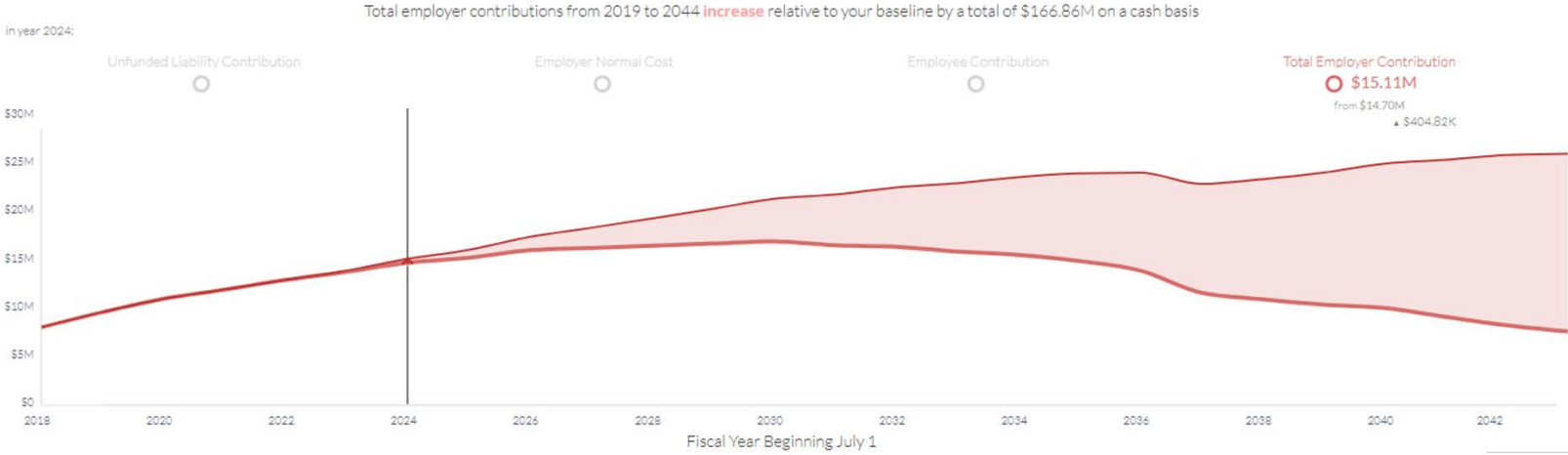
# One-Time Event

## 4.7% Return in 2019, 7% Return Onwards



# New Normal

## Continue 1-Year Average Return (4.7%)



# What Can Be Done?

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## LOCC Pension Solutions

### What Cities Can Do Today

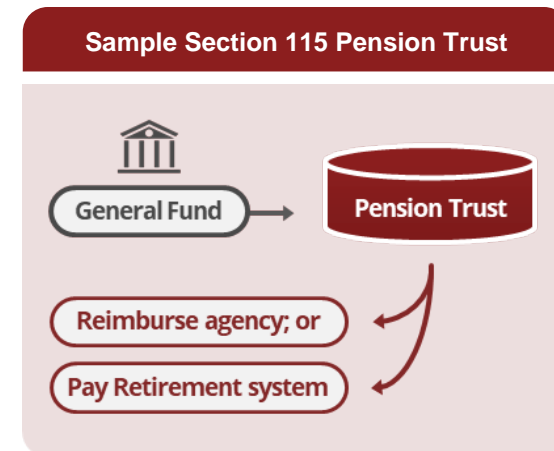
Many cities have already exercised their limited options under current law to address the fiscal challenges attributed to growing pension liabilities, which include:

- 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.

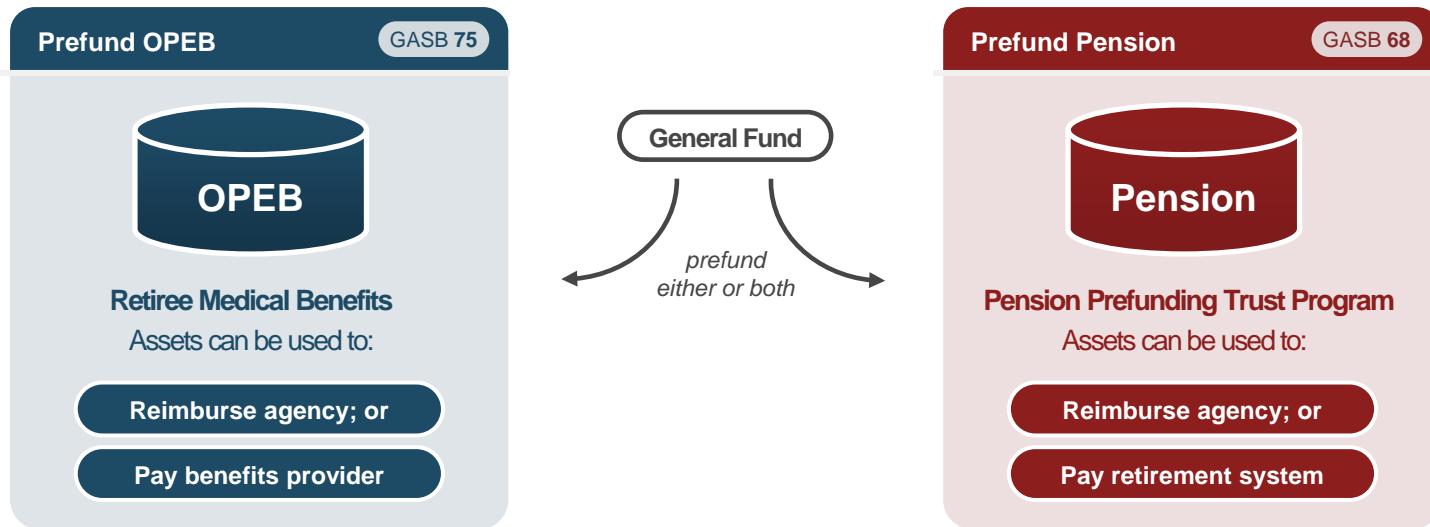
# What Are Section 115 Pension Prefunding Trusts?

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- **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



## Financial Stability

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



## Anytime Access

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



## Flexible Investing

Allows separate investment strategies for all OPEB and pension subaccounts.

# Why Prefund Pension Obligations?

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1

## Stabilize Costs

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

2

## Local Control

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

3

## Protection

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

4

## Diversified Investing

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

5

## Rainy Day Fund

Emergency source of funds when employer revenues are strained in difficult budgetary or economic times

6

## 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?

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

# Investment Flexibility

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- 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).

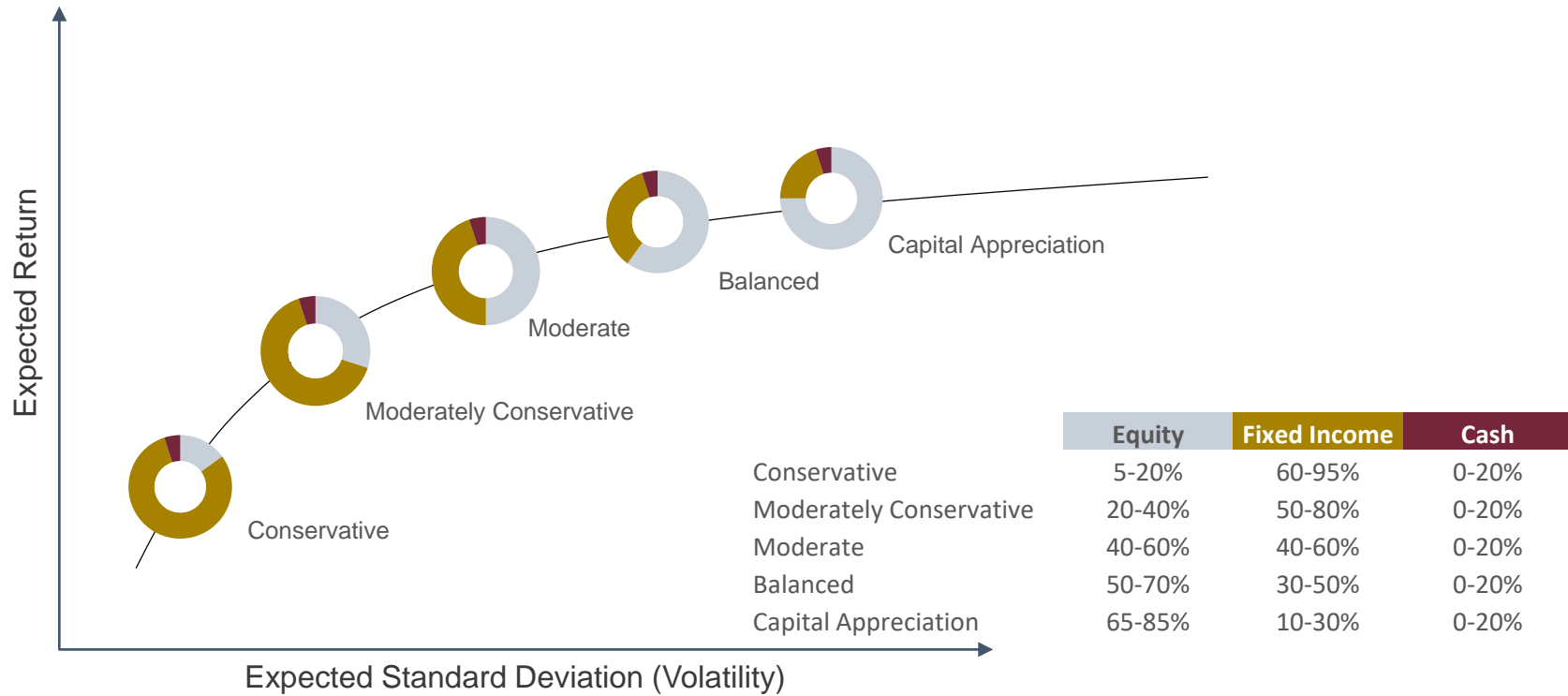
**GOV § 53216** (Pension)

**GOV § 53620** (OPEB)



# Determine Strategic Allocation Strategy

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



# Sample Portfolio Returns

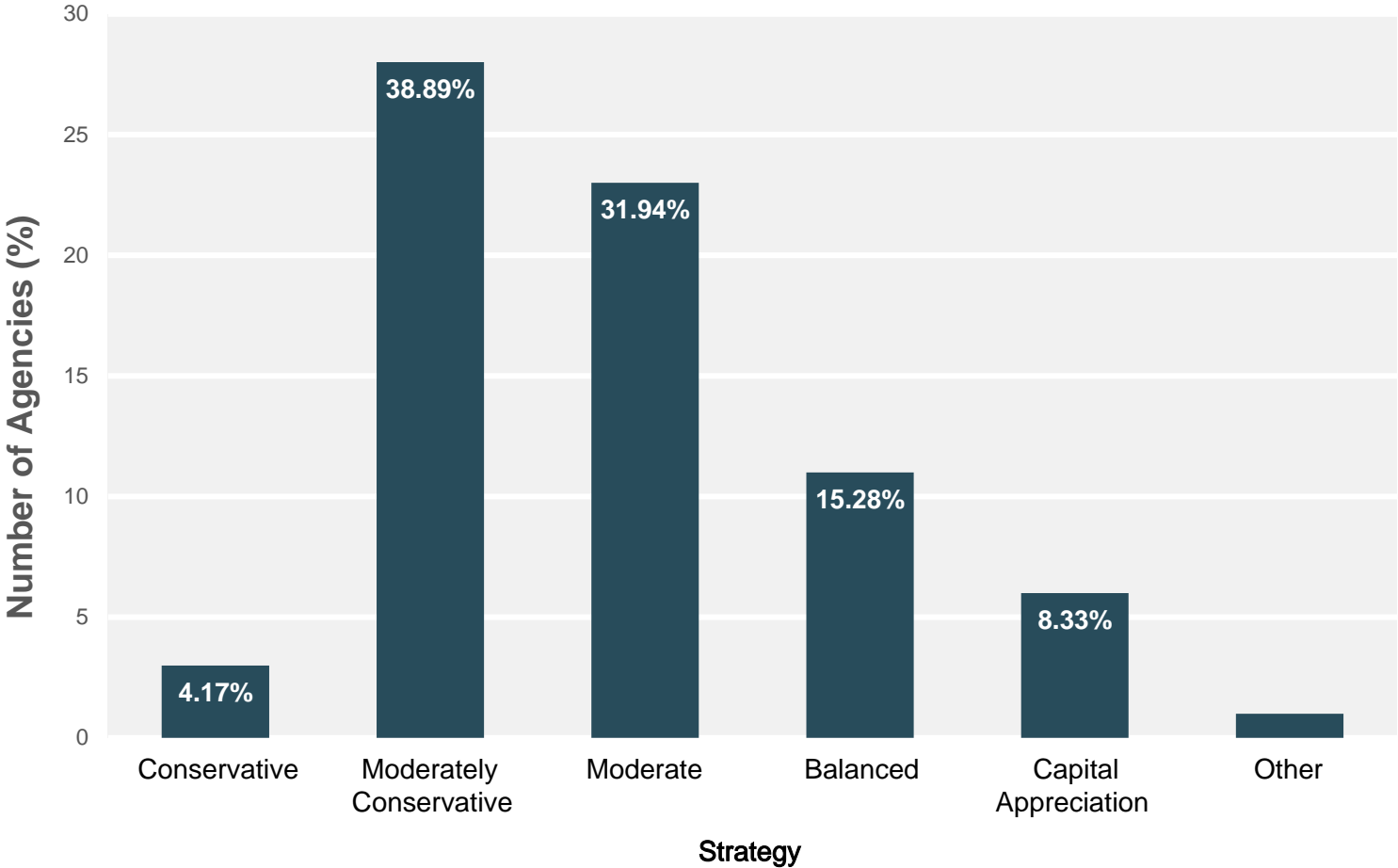
As of June 30, 2020

## ACTIVE PORTFOLIO RETURNS

Strategy	Equity (%)	1 Year	3 Years	5 Years	10 Years
Capital Appreciation	65-85%	2.66%	6.26%	6.42%	9.06%
Balanced	50-70%	3.51%	6.07%	6.01%	8.24%
Moderate	40-60%	3.96%	5.77%	5.67%	7.48%
Moderately Conservative	20-40%	4.87%	5.22%	4.90%	5.97%
Conservative	5-20%	5.78%	4.93%	4.41%	4.75%

# What Investment Options Are Typically Used?

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# Sample Funding Policies

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

# Pension Funding Policy Elements

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

Pension Funding Policy Elements	Example 1: CalPERS (Baseline)	Example 2: Lower Funding Target (Current Practice)	Example 3: Medium Funding Target	Example 4: Higher Funding Target
% Funded Goal (Range)	100%; no lower element of range	80% - 100%; Target of 85%	80% min - 100%; Target of 95%	90% - 100%+; Target of 100%+
Time frame	30 years	Within 10 years	Within 10 years	Within 10 years
Funding Components	Normal Cost (NC) calculated at 7.0% Discount Rate	(+) Cost-sharing with employees (see table above for specific rates)	(+) Additional cost-sharing with employees	(+) Recalculate the UAL with the same lower DR (phase-in)
	Changes in actuarial assumptions amortized over 20 years	(+) Using a more conservative discount rate (DR) for calculation of normal cost	(+) Identify funding for the pension obligation through Budget	(+) Amend existing BSR policy, 100% excess BSR allocated for pension costs (all funds contribute a commensurate amount)
	UAL amortized over 30 years for gains/ losses; calculated at 7.0% Discount Rate (20 years beginning 6/30/2019)	(+) Amend existing BSR policy, 50% excess BSR can be allocated for pension costs (all funds contribute a commensurate amount) (+) Reach one-year of funding for CalPERS ADC in 115 Trust Fund (invest moderately conservatively); subsequent proactive funding to CalPERS as ADP		
Allowable Uses of Funding Components	NC covers pay-go portion; UAL portion pays off unfunded liability in 30 years if CalPERS investment returns met	(+) Use of 115 Trust Fund funding to be addressed through annual budget process or separate City Council approved action. Pension Rate Stabilization Program	(+) Fresh start in concept for the Safety group, beginning in a target year	(-) Contractual Partial Fresh Start for the Safety group beginning in a target year in-lieu of fresh start in concept
Service Delivery Outcomes	Continue services throughout the City including the ability to keep up with the cost of doing business as well as limited strategic investments.	Continue current constraints and limitations on service delivery including an inability to keep up with the cost of doing business. Prioritization would continue to be necessary annually through the budget process.	(+) City Manager to identify plan to address additional contributions to pension as part of annual budget process (+) Impacts on Service Delivery and/or structural additional revenue	(+) Significant adverse impacts on service delivery levels; additional revenue
Fiscal Impact	Savings to the City	Continue \$5.0 million structural adjustments necessary to maintain contributions	Additional structural adjustments Estimated at ___%* of the General Fund	Significant additional structural adjustments Estimated at ___%* of the General Fund

(+) Indicates that this is in addition to the step to the left while (-) indicates that this is instead of the step to the left.  
 \* 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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# Thank you for attending!

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