STAFF REPORT

Meeting Date: February 17, 2015

To: Honorable Mayor & City Council

From: Don Rhoads, Administrative Services Director/Chief Financial Officer

Subject: Update on Pension Rates and Unfunded Liability Status

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INTRODUCTION

This report provides information on the City's current pension rates and unfunded liability (UL) and offers options for future consideration. The City recently received its annual actuarial report from CalPERS providing updated estimates of future pension rates and the level of unfunded liability. Because CalPERS reporting lags by over a year, this report is based on fiscal year 2012-13 activity. Since fiscal year 2012-13 was a positive earnings year for CalPERS (13.2%), the news this year is generally good. Rates are still rising and the UL is still very large, but the level of growth in rates has moderated considerably and projections now show rates finally leveling off by 2019-20, providing something of a light at the end of the tunnel. Unless Council would like to discuss the options addressed in this report at this time staff will bring this topic to the Citizen's Budget Review Committee for their input and review, and then return to Council at a later date for discussion and direction.

DISCUSSION

The table on the next page shows projected pension rates for the City's "Miscellaneous" (non-safety) employees as well as safety (police and fire) employees. Beside the projected rates the table also shows the projections from last year and the change for comparison. As you can see, in almost all cases the projected rates going out to 2019-20 have declined from last year's projections. Whereas I previously reported that rates five years out were projected to be over 56% for safety and over 27% for miscellaneous employees, now those projections are 4%-5% lower at 51% and 23%, respectively. Note that an additional year has been added to the projection (2020-21) and is projected to level off at about those 51% and 23% levels. This is due in part to the effect of the savings expected from the lower cost Public Employee Pension Reform Act (PEPRA) pension plans enacted in 2012. As more employees join the City under those less expensive plans pension costs should flatten out and in time begin to decline, assuming CalPERS continues to meet or exceed its actuarial assumptions such as its 7.5% earning target.

Also note that for the 2014-15 Miscellaneous plan the rate dropped by 0.4%. This was due to the additional $2 million allocated to reduce the rates and UL in the 2013-14 budget, which will be further discussed below.

Projected Pension Rates

	Miscellaneous			Safety		
Fiscal Year	Projected Rate	Previous Projection	Change	Projected Rate	Previous Projection	Change
2014-15	17.2%	17.6%	-0.4%	37.2%	37.2%	0.0%
2015-16	18.8%	18.8%	0.0%	41.3%	39.5%	1.8%
2016-17	20.2%	22.3%	-2.1%	44.5%	45.1%	-0.6%
2017-18	21.2%	24.1%	-2.9%	46.7%	48.8%	-2.1%
2018-19	22.2%	25.9%	-3.7%	48.9%	52.6%	-3.7%
2019-20	23.2%	27.6%	-4.4%	51.2%	56.4%	-5.2%
2020-21	23.2%			51.1%		

Likewise, the news regarding the City's unfunded pension liability is generally good because the liability decreased. However, as I described at the mid-year review and again at a budget study session earlier this year, it is somewhat complicated this year because the Governmental Accounting Standards Board (GASB) changed the methodology for calculating the value of assets in the plan from the "Actuarial Value of Assets" (AVA) to the "Market Value of Assets" (MVA) approach and CalPERS has implemented this change. The GASB believes this approach will more accurately represent the level of assets and, therefore, the level of the unfunded liability. The advantage of using the MVA approach is that it is more understandable in that the value of assets is simply the market at a point in time (i.e. June 30), which is fairly straightforward. The disadvantage of the MVA approach is that it is much more volatile. The AVA, however, uses actuarially determined smoothing methods to provide a less volatile picture over time.

The table on the next page shows the change the plan assets and UL showing, for comparison purposes, both the old AVA and new MVA approaches. As you can see, in both cases the UL dropped:

- a modest $0.5 million in the case of the more stable AVA approach to $125.5 million; and
- a more substantial $21.2 million, to $191.7 million, in the case of the more volatile MVA approach.

Funding levels also increase overall in both cases to 81.3% (AVA) and 71.4% (MVA).

Change in Unfunded Pension Liability
(millions)

	Misc Plan		Safety Plan		Total	
	2012	2013	2012	2013	2012	2013
Accrued Liability	$278.1	$288.4	$370.3	$382.9	$648.4	$671.3
Actuarial Value of Assets	229.8	242.4	292.6	303.5	522.3	545.9
Unfunded Liability (AVA basis)	($48.3)	($46.0)	($77.7)	($79.5)	($126.0)	($125.5)
Percent Funded (AVA basis)					80.6%	81.3%
Market Value of Assets	191.6	213.4	243.8	266.3	435.5	479.6
Unfunded Liability (MVA basis)	($86.5)	($75.1)	($126.4)	($116.7)	($212.9)	($191.7)
Percent Funded (MVA basis)					67.2%	71.4%

Though CalPERS did not provide information regarding the UL at June 30, 2014, the City's outside actuary, John Bartel, did calculate an estimate of the UL as of that date to give the City an idea of where the liability is headed. Given the good earnings year CalPERS had in 2013-14, the City's UL is projected to drop again from the $191.7 million (MVA basis) shown above to approximately $149 million (MVA basis) as of June 30, 2014, resulting in an estimated funding level of 78.8%. This is good news and shows continued progress toward reducing the overall UL. However, the liability is still significant so the City Council has indicated a desire to pay down the UL. Following is a discussion on options for how to accomplish this goal.

<u>Additional Funds to Reduce Pension Rates and Unfunded Liability</u>
Last fiscal year (2013-14) the City Council allocated $2 million toward paying down the pension UL, which was sent to CalPERS. This reduced the Miscellaneous plan pension rate by 0.383%. This may not sound like much but is creating a real dollar savings and is projected to save approximately $141,000 this fiscal year, a return of 7.3%. The City Council allocated an additional $2 million in the current year's budget (2014-15) as well. The options given to the City Council at budget time were very limited as follows:

1. Make only the required pension payments each year
2. Advocate at the State level for additional pension reform legislation
3. Make additional payments to reduce future pension rates

When the budget was presented last spring, however, the City Council requested additional options because they were not comfortable at that time with allowing the new $2 million allocation to be sent to CalPERS again as it had been the year before. Since that time staff has been researching this matter and discussing options with the City's actuary and legal counsel and has discovered another option only recently approved by the Internal Revenue Service, and that is a Section 115 Trust.

Option for Paying Down the Pension Unfunded Liability

A Section 115 Trust (referring to Section 115 of the Internal Revenue Code) is an irrevocable trust, which means dollars put into that trust cannot be taken back out except to satisfy the purposes of the trust. Section 115 Trusts have been used for some time as a vehicle for setting aside funding to reduce an agency's unfunded retiree medical (i.e. Other Post-employment Benefit – OPEB) liabilities, but this vehicle had never been approved by the IRS for funding pension unfunded liabilities until a few months ago. While the irrevocability of the Trust limits how the funds can be used, it also allows the Trust to invest proceeds in higher earning assets that the City does not have access to by law. This would give the City more control over how assets were invested, but would also carry with it the risk of potential loss of assets should the economy take another steep dive.

Here are some of the key features and pros/cons of a Section 115 Trust:

- Administered by Public Agency Retirement Services (PARS) – a privately held corporation, not a state agency and not related to CalPERS. PARS currently manages the City's retirement plan for the City's part-time/seasonal employees;
- 375,000+ participants;
- $1.6 billion in assets under administration;
- PARS has requested a private letter ruling from IRS to establish their Section 115 Trust – ruling timeframe is 4-6 months;
- Pros:
    - Alternative to sending funds to CalPERS;
    - Maintain greater local control of assets. Investments can be tailored to the City's desires and risk tolerance;
    - Would reduce City's unfunded pension liability;
    - Would reduce net pension liability on City's balance sheet;
    - Higher potential earnings than City can achieve;
- Cons:
    - City retains fiduciary responsibility for the program while there is potential for negative investment performance;
    - Funding a Section 115 Trust would lower UL but not pension rates that are calculated by CalPERS;
    - Assets placed into the Trust can only be earmarked for pension funding purposes and cannot be used for other purposes should an unexpected need arise;
    - Adds administrative complexity (new program to administer, oversight of plan assets, etc.);
    - Very limited precedent for utilizing a Section 115 Trust for pension funding purposes – only one other agency is known to have used this tool.

So the Council can consider all options, here are some key features and pros/cons regarding using CalPERS to reduce the UL:

- The Public Employee Retirement System (CalPERS) is an agency of the state of California;
- 1.7 million participants;
- $301.1 billion in assets under administration (as of 12/22/14);
- Pros:
  - Would reduce City's unfunded pension liability;
  - Would also lower pension rates resulting in ongoing bottom-line savings (estimated savings of $141,000 in current fiscal year from last year's $2 million contribution);
  - Administratively easier to implement since there is nothing new to set up and administer;
  - Would reduce net pension liability on City's balance sheet;
  - Higher potential earnings than City can achieve;
- Cons:
  - Assets placed into CalPERS can only be earmarked for pension funding purposes and cannot be used for other purposes should an unexpected need arise;
  - Do not have control over how assets are invested;

FISCAL IMPACT

Immediate fiscal impact would be allocation of $2.5 million of the 2013-14 budget surplus to reduce the City's unfunded pension liability. Longer term fiscal impacts could also include a reduction in pension costs depending on option chosen by Council. For example, allocating the additional funds to CalPERS would reduce the pension rate by approximately 0.5% and save an estimated $176,000 annually. Allocating the funds to a new Section 115 Trust would not have an immediate impact on pension rates but would reduce the pension UL.

As part of the Council discussion regarding the allocation of the 2013-14 budget surplus staff has suggested adding another $2.5 million for reducing the pension UL to the $2 million already earmarked by Council during the last budget process, for a total of $4.5 million. Unless Council would like to discuss the options addressed in this report at this time staff will bring this topic to the Citizen's Budget Review Committee for their input and review, and then returning to Council at a later date for discussion and direction.

Don Rhoads