STAFF REPORT

Meeting Date: April 5, 2016

To: Honorable Mayor & City Council

From: Don Rhoads, Chief Financial Officer

Subject: Review of Pension and Retiree Medical Unfunded Liabilities and Options for Reducing these Liabilities

Attachments: None

INTRODUCTION

The purpose of this report is to give the City Council an update on the status of the City's retiree medical and pension unfunded liabilities and discuss options for reducing these liabilities.

DISCUSSION

Background

The City provides retiree medical benefits to all regular employees that vary depending on when they joined the City. In general, for employees who started with the City before January 1, 2010 an employee who retired may be eligible to receive medical benefits paid for by the City under its defined benefit plan. In 2010 non-safety employees were offered the opportunity to switch from this defined benefit plan to a new defined contribution plan under the City's Alternative Retiree Medical Program (ARMP). This plan issued bonded debt to pay those employees who voluntarily chose to switch for the actuarially determined value of their retiree medical benefit up to that point. Employees joining the City after January 1, 2010 were automatically put into a new defined contribution plan in which monthly contributions are made to an employee's Retirement Health Savings (RHS) account. This approach limits the City's liability for increases in medical costs for these newer employees and for ARMP employees going forward.

Despite these steps already taken by the City to reduce and limit the accrual of liabilities for retiree medical costs, the City still retains significant liabilities for 1) those employees that joined prior to January 1, 2010 that did not opt for the ARMP program; and 2) by state law, all regular employees in the City's medical plan are required to be provided a minimum amount upon retirement to be used toward their medical costs, which is currently $125 per retiree per month. These two factors generate a retiree medical (also referred to as an "other post-employment benefit" or OPEB) liability for the City. While the liability is much less than it would have been had the City not taken the steps of

creating a defined contribution plan for all new employees and the ARMP plan, it is still significant at $99.3 million, of which $40 million is funded, according to the June 30, 2015 actuarial report. This is reflected in Table 1 below.

In addition to the OPEB liability, the City also has significant liabilities for its pension plan. As for pension liabilities, Table 1 below shows the total unfunded liability for the safety and non-safety pension plans ($114.3 million and $69.6 million respectively) as well as the currently outstanding funds available ($4.5 million) to reduce this liability.

Unfunded Liabilities Summary
(in millions)

	OPEB	Pension	Total
Safety	$61.4	$114.3	$175.7
Non-safety	37.9	69.9	$107.8
Total Liability	99.3	184.2	283.5
Funds Available	40.0	4.5	44.5
Unfunded Liability	$59.3	$179.7	$239.0

Table 1

Retiree Medical Unfunded Liability (Other Post-employment Benefits – OPEB)
There have been a number of significant changes since the last OPEB actuarial report, dated June 30, 2013, was produced. The effect of these changes has been to double the actuarial liability for OPEB costs as detailed in Table 2 below.

Changes in OPEB Actuarial Liability Since 2013 Report

2013 OPEB Actuarial Liability		$49.0
Implied subsidy	New actuarial standard	19.9
Discount rate	Use 4% instead of 5%	12.1
Experience since last report	Normal change in liability	4.3
Improved mortality	More recent experience study	2.0
Participation rate	More conservative assumptions	1.9
Medical trends	More conservative assumptions	1.6
Fiscal year vs calendar year	Use FY rather than CY	1.5
Other changes in assumptions		7.0
2015 OPEB Actuarial Liability		$99.3

Table 2

The most significant of these changes has been related to a new actuarial standard of practice implemented in 2014 and the use of a more conservative discount rate in the calculation of the liability. Regarding the new actuarial standard, before last year actuaries generally did not consider in their calculations the fact that retirees were able to purchase medical insurance at the same rates as active employees, even though medical costs typically grow significantly the older we get. This "implied subsidy" of retiree medical plan rates by active employees is now taken into consideration in actuarial calculations. This factor alone increased the OPEB liability by more than 40% even though nothing in the plan changed other than how the actuarial calculations were performed. Another significant change from the 2013 report was the lowering of the discount rate used from 5% to 4%. This is the amount the City might expect to earn over the very long run on its investments set aside for OPEB. However, our actuary was not comfortable with the higher 5% rate used in the last report, and staff concurred.

Note that higher earnings may be possible if OPEB investments (like the $40 million currently set aside – see Table 1 and Table 3) are deposited into an irrevocable Section 115 Trust (Trust). This is because, unlike the investment options available to the City, a Trust can make investment choices that have the potential to earn a much better long-term return. For example, Table 3 below shows the net OPEB unfunded liability with earnings assumptions at the 4%, 6%, and 7.5% levels. At a 6% rate the unfunded liability drops to $37.4 million and at 7.5% it drops further to $25.6 million compared to $59.3 million at the current assumed rate of 4%.

Unfunded OPEB Liability with Discount Rate at 4% vs 6% vs 7.5%

(millions)

Actuarial Liability	4%	6%	7.5%
Safety	$61.4	$48.5	$41.5
Non-safety	37.9	28.9	24.1
Total Liability	$99.3	$77.4	$65.6
Funds currently available	40.0	40.0	40.0
Net OPEB Unfunded Liability	$59.3	$37.4	$25.6
Percent funded	40%	52%	61%

Table 3

Assuming a long-term earnings rate of 7.5%, however, may require a more aggressive portfolio of investments than the City is willing to tolerate. If so, a more conservative long-term earnings assumption, like 6%, could be selected instead when establishing policies for a Section 115 Trust.

Pension Unfunded Liability

The change in the pension unfunded liability from 2012 through 2014 (latest available information from CalPERS) is shown in Table 4 below. On the plus side, the total unfunded liability dropped from over $212 million in 2012 to $184 million in 2014, largely due to two good earnings years in 2013 (13%) and 2014 (18%). This also moved the funding level up from 67% funded in 2012 to 75% funded in 2014. This is good progress, however, on the negative side, in fiscal year 2015 CalPERS investments earned only 2.4%, falling short of their projected rate of 7.5%. This will likely have the effect of increasing the unfunded liability when the 2015 actuarial reports are completed in the fall. CalPERS points to their long-term earnings record which, although for 10 years it has fallen short at 6.2%, the 20 and 25 year returns have been 7.7% and 8.2% respectively.

It is also important to note that with the passage of the Public Employee Pension Reform Act (PEPRA) in 2012, which mandated a lower cost pension plan for public employees new to the CalPERS pension system, the number of City employees in either the PEPRA plan or the lower cost 2nd tier safety plan has grown to 173, or 20% of the employee population. It will take some time, but over time as this number continues to grow, long-term pension costs will be reduced from what they would have been.

Change in Unfunded Pension Liability

(millions)

	Misc	Safety	Total		
	2014	2014	2012	2013	2014
Accrued Liability	$320.3	$417.1	$648.4	$671.3	$737.4
Market Value of Assets	250.4	302.8	435.5	479.6	553.2
Unfunded Liability	($69.9)	($114.3)	($212.9)	($191.7)	($184.2)
Percent Funded			67.2%	71.4%	75.0%

Table 4

Should the Council chose to move forward with a Section 115 Trust, funds transferred into the Trust (such as the $4.5 million currently set aside in the General Fund – see Table 1) for pension unfunded liabilities could, like the OPEB funds mentioned earlier, be invested at a higher earnings rate than is currently possible in a City fund. CalPERS currently assumes an earnings rate of 7.5%. Despite CalPERS' earning track record, some have questioned whether that assumption is achievable in the long run. If the City chose to be more conservative than CalPERS, a lower earnings assumption, again, say 6%, could be selected as a target for the Trust. This would be reviewed over time and if CalPERS is correct in their 7.5% earnings assumption the City would be able to pay off its unfunded liability sooner using funds accumulated in the Trust. If CalPERS is incorrect and they earned less than 7.5% over time, the City would be prepared for that contingency by using funds in the Trust to help offset the additional pension payments

CalPERS would be requiring. In other words, the Trust would act as a risk mitigation tool should CalPERS turn out to be too optimistic in their earning assumptions.

Options for Reducing Unfunded Liabilities

1. Make only the required payments each year
2. Make payments in addition to the required amount
    - OPEB: payments would go to existing Benefit Fund
    - PERS: payments would go to CalPERS
3. Make additional payments to a Section 115 Trust

Option 1 above is not a "do nothing" option. By making only the required payments, the OPEB unfunded liability would be amortized over 22 years, and the pension unfunded liability over 19 and 25 years respectively for non-safety and safety.

Option 2 for OPEB would mean adding to the $40 million already set aside for this liability in an existing City fund. This has the advantage of keeping the funds in the City's full control. However, because the City's investment options are very limited, the earnings rate will always be quite low, generating a high actuarial liability. To reduce the pension liability, additional payments, such as the existing set-aside of $4.5 million, could be sent to CalPERS, as the City did in 2013. This has the advantage of lowering the liability and the pension rates, but the City loses control of those funds once they are deposited with CalPERS.

Option 3 provides for the benefits of some local control of the funds with the potential for higher earnings than the City can generate. Also note that though funds deposited in a Section 115 Trust for OPEB would not be interchangeable with funds deposited for pension liabilities, the Trust can be designed with sub-accounts to provide a funding vehicle for both OPEB and pension liabilities to reduce administrating costs. Here are some of the pros and cons of establishing a Section 115 Trust:

Pros:

- Alternative to sending funds to CalPERS.
- Maintain greater local control of assets.
- Reduce City's unfunded pension liability (UL).
- Reduce net pension liability on City's balance sheet.
- Higher potential earnings than City can achieve.

Cons:

- City retains fiduciary responsibility for the program
    - Potential for negative investment performance.
- Funding a Section 115 Trust lowers UL, but not pension rates.
- Assets in Trust can only be earmarked for pension funding.

Table 5 below outlines an approximate timeline of events required to establish a Section 115 Trust:

Staff works with City Treasurer and Citizen's Budget Review Committee to develop policies regarding establishment of a Section 115 Trust	March-June 2016
City Council adopts resolution that authorizes the establishment of a Trust	July 2016
Meeting with Investment Manager to determine appropriate risk strategy for plan assets and to develop investment policy and guidelines	August 2016
Council approves initial deposit to Trust Fund	September 2016
City develops policies and procedures for future annual contributions and plan distributions	September 2016

Table 5

FISCAL IMPACT

The primary fiscal impact at this point would be staff time necessary to implement the Section 115 Trust, should Council direct staff to pursue this option.

RECOMMENDATION

It is recommended that City staff work with the City Treasurer and the Citizen's Budget Review Committee to establish a Section 115 Trust as a vehicle for holding existing funds set aside for unfunded liabilities ($40 million for OPEB and $4.5 million for pensions) plus any additional payments the Council may choose to appropriate for the purpose of reducing the pension and OPEB unfunded liabilities in the future. Staff would return this summer with the appropriate action items necessary to establish the Trust.

Don Rhoads
Approved By