City of Richmond

Finance Department

AGENDA REPORT

DATE:	July 19, 2022
TO:	Mayor Butt and Members of the City Council
FROM:	Anil Comelo, Interim Deputy City Manager Delmy Cuellar, Director of Finance
Subject:	Funding Strategy for Pension and OPEB Liability through a 115 Trust
FINANCIAL IMPACT:	This action does not require an appropriation at this time. However, the City has funds which have been reserved in the General Fund for pension and OPEB liabilities. If approved tonight, the Finance staff will come back to the City Council to request approval for appropriation of these funds for deposit into the proposed Trust fund.
PREVIOUS COUNCIL ACTION:	Click or tap here to enter text.
STATEMENT OF THE ISSUE:	The City has a sizable CalPERS unfunded balance of approximately $366.9 million. The City has only been paying the required minimum and the balance has grown by over $162 million in the last seven (7) years. It would, therefore, be prudent to start pre-funding a trust to address the liability.
RECOMMENDED ACTION:	APPROVE an agreement with PARS and the execution of all necessary agreements and plan documents associated with establishment of the new IRS approved PARS 115 Combination (OPEB & Pension) Trust – Finance Department (Anil Comelo 620-6600/Delmy Cuellar 620-6790).

DISCUSSION:

The City of Richmond in partnership with its employees have taken several steps during the last six years to manage Other Post-Employment Benefits (OPEB) liabilities and costs. These actions represent responsible financial management that have lowered the City's costs and positioned the City to achieve savings into the future. Employees hired after January 2013 that previously were not members of the CalPERS receive a lower pension benefit per the California Public Employees' Pension Reform Act (PEPRA) signed by the Governor Brown in 2012. Under PEPRA, the contribution rates are equally shared between the employee and the employer. Public Safety employees hired under PEPRA contribute 12.50 percent of their salary towards their retirement and non-safety employees contribute 7.25 percent of their salary towards their retirement. Since these employees are new CalPERS members, they do not carry the burden of paying for the unfunded liability. The concept of setting aside funds for long-term liabilities (pension and OPEB) has been previously discussed and in fact the city already has an OPEB-only trust and has assets of about $32.1 million as of March 31, 2022.

California Public Employee Retirement System (CalPERS)

The City's CalPERS actuarial reports dated June 30, 2020, included an unfunded liability of $366.9 million with a funded level for the safety plan of 67.5 percent and non-safety plan of 73.3 percent. It is important to recognize that although the unfunded liability increased by $16 million during the one-year period, CalPERS actuarial reports have changed significantly in recent years with their Board changing demographic assumptions, implementing a smoothing feature, and lowering the expected rate of return (ROR) on investments, all of which cause the unfunded liabilities to increase, which in turn drive the City's required contributions higher. For CalPERS, one of the most critical assumptions in attaining its full funding goals is the ROR on its investments. Prior to July 2021, CalPERS' annual ROR assumption was 7.0 percent. If the 7.0 percent rate of return is not realized, then contributions from employers and employees must increase. Unfortunately, the 7.0 percent ROR has not been achieved in the past two years (6.7. percent in FY 2018-2019 and 4.3 percent in FY 2019-2020) and the outlook from the investment community and actuaries for a 7.0 percent annual rate of return was increasingly pessimistic. As a result, effective July 2021, CalPERS' Board approved a reduction in the ROR to 6.8 percent. This most recent reduction has not been reflected in the current actuarial reports.

The changes in the unfunded accrued liability (UAL) due to changes in actuarial assumptions are amortized over a fixed 20-year period with a five (5)-year ramp up at the beginning and a five (5)-year ramp down at the end of the amortization period. As a result of the ramp up and the effective date of the increase, it will be seven years until the full impact of the discount rate change is completely phased in.

<u>Pension 115 Trust Benefits</u>

A Section 115 trust is a tax-exempt investment vehicle authorized by the Internal

Revenue Code (IRC) used to prefund essential government expenses (e.g., retiree medical and retirement plan benefits). To remain tax-exempt, assets held in a Section 115 Trust are designated as irrevocable, meaning they must be used to fund the City's OPEB (retiree medical) or retirement plan obligations. Additionally, monies held in such trusts can be invested in accordance with the rules governing those trusts, which are different than the investment rules for the City's pooled investments. Setting aside funds in a Section 115 Trust can potentially earn a higher rate of return than if funds were invested with the City.

Funds placed in a Section 115 Trust can remain in the trust until a point in time when the City chooses to draw on its assets to pay annual benefit obligations or reimburse the City for its pension expense. The City may withdraw funds by adopting policies and procedures that include requiring action be taken by City Council. The City would set its own restrictions on how and when the funds can be used and withdrawn.

Pre-funding post-employment benefit liabilities is a best practice recommended by the Government Finance Officers Association (GFOA). Some of the other benefits that a Section 115 Trust program can provide are summarized below:

- City has complete local control over assets, including contributions, disbursements and the timing, amount, and risk tolerance level of investments;
- Assets can be transferred to the retirement system at the City's discretion and potentially reduce/eliminate large fluctuations in employer contribution amounts; and
- Can use deposited cash as an emergency source of funds in the event revenues are strained during difficult budgetary or economic times by reimbursing the General Fund for pension related obligations for current and prior year.

Combined OPEB/Pension Trust

Unfunded retirement liabilities and the inevitable CalPERS contribution rate increases are serious problems that are not unique to Richmond. In response to this growing issue, a number of proactive agencies are establishing not only OPEB Trusts, but Pension Rate Stabilization Program (PRSP) Trusts. To date, the most widely adopted PRSP for governmental agencies has been a plan pioneered by PARS and adopted by over 270 agencies including 132 cities. As outlined above, the City has an existing irrevocable OPEB trust with PARS to help fund its retiree health benefits. Today's action proposes to set up a new combination irrevocable Trust to replace the existing OPEB Trust, with one that will have two accounts. One account will be for the existing OPEB assets that have been contributed since 2008 (as well as future contributions) and the other account will be for prefunding pension liabilities. Exhibit 1 is the IRS Private Letter Ruling that verifies the tax-exempt status of the PARS combination trust program. Including a pension component to the Trust will benefit the City in three notable ways.

First, assets placed into the pension account will potentially earn a greater return over time than where they are currently invested in the Local Agency Investment Fund (LAIF). The funds will earn a return closer to that earned by CalPERS, but unlike the funds that have been forwarded to CalPERS, these funds will be controlled by the City, including establishing the risk tolerance level.

Second, the Pension Rate Stabilization assets can be used to pay CalPERS annual employer required contributions at the City's discretion, which will help cushion the financial impact of the expected sharp increases in rates.

Finally, rating agencies perceive prefunding into a Trust more favorably than earmarking funds within the City's pooled cash/investments and could positively impact the City's credit rating.

As an alternative approach, the City might consider making additional advance contributions to CalPERS instead of establishing a separate Trust with PARS. In this instance, CalPERS would amortize additional funds the City chooses to contribute over 30 years, causing very little immediate impact on the reduction of annual contribution rate. The proposed Trust with PARS allows annual contributions, and accumulated assets will help the City indirectly offset its pension liabilities. If the City Council does not authorize the PARS pension trust and chooses not to make additional contributions to CalPERS, the funds will remain reserved in the General Fund to be used for paying future pension costs. These reserves will not be applied to the Net Pension Liability presented in the City's future financial statements and will earn a much lower rate of return.

City staff considered two providers of prefunding of pension.

Option 1 – PARS

The Public Agency Retirement Services (PARS) Pension 115 Trust includes 5 risk tolerance levels with choice of active or passive for a total of 10 risk tolerance options and can customize a portfolio valued at least $5 million. (Passive investing means to hold at a representative benchmark whereas active involves constant attention to beat the benchmark). The trust is managed by PARS (administrator), HighMark Capital Management (investment advisor) and US Bank (trustee). HighMark Capital Management is a subsidiary of Union Bank; however, Union Bank is currently in the process of being acquired by US Bank. The total management fees are 60 basis points (0.60 percent) of assets under management with a blended fee of 39.9 basis points (0.399 percent) based on current $30 million plus asset level. As of September 30, 2021, PARS reported a one-year return of 5.4 percent - 23.25 percent within their five active portfolio options. Termination requires 30 days advanced notice.

Option 2 – CalPERS

The CalPERS Pension 115 Trust, the California Employers' Pension Prefunding Trust

(CEPPT) is a self-funded, not- for-profit program where participating employers pay for the total costs of the trust option. The CalPERS program is managed by CalPERS (administrator), State Street Global Advisors (investment manager) and State Street Bank (trustee). The CEPPT has an all-inclusive fee rate of 25 basis points (0.25%) of employer account assets under management. There are no other fees. All employers pay the same fee rate, which may be higher or lower in the future per CalPERS. As of September 30, 2021, strategy 1 reported a one-year return of 13.43 percent while strategy 2 reported a one-year return of 5.82 percent. Termination requires 150 days advance notice and CalPERS Board approval. They only have two investment options and no choice of active or passive options. Also, they do not have IRS approval for CEPPT.

City Staff Recommendation

City staff met with representatives of CalPERS and PARS to determine how to proceed. While the CalPERS option can provide adequate services, City staff's determination and evaluation process concluded that PARS would provide the best overall value for the City. PARS is the pioneer of pension trusts with a higher level of service provided with administering the trust, including assistance with developing an investment policy, funding recommendations along with the flexibility of investment options offered through HighMark Capital. Additionally, PARS is partnered with U.S. Bank, the trustee and plan fiduciary for safeguarding member assets, and provides for mutual indemnification in their member agreement. City staff also chose PARS because the City already has a 115 Trust for OPEB with PARS and the new combination trust set-up will be at no cost to the city. Also, as assets grow, fees will go down based on PARS tiered fee schedule. Finally, the PARS 115 combo trust has IRS approval.

Given the high level of service and responsiveness already given to its members, City staff has concluded that having PARS as the Trust Administrator will be less demanding of Finance staff time and minimize impacts to ongoing project and responsibilities. City staff reached out to references and received positive reviews of PARS. Clients were satisfied with the service being provided, due to PARS being easy to work with, its responsiveness, and the ongoing reporting provided. PARS will provide monthly, quarterly, and semi-annual reports on performance activity of the trust.

Funding Policy

The City's FY 2022-2023 payment for CalPERS is $29,205,372. CalPERS provides a 3.5 percent incentive for paying in a lumpsum in July of each year. If the City took advantage of this option in July the City would save $971,477. In an effort to address the City's unfunded liabilities, staff recommends a practice whereby this annual savings be used to fund the 115 Trust. Additional contributions can be made as directed by the City Council.

Remuneration: PARS and HighMark generate income based upon a percentage of the invested assets. The City will pay fees to PARS for administration of the trust fund and to US Bank/Highmark Capital for custodial and investment of the plan assets based on the amount of funds under management and according to a sliding scale outlined in the Administrative Services Agreement. The fee structure is the same structure that is currently in place with the OPEB Trust that was established in 2008. The fees will be netted against interest earnings in the Trust. Fees will be determined based on the combined assets of the OPEB and Pension accounts which will result in lower fees as assets build.

DOCUMENTS ATTACHED:

Attachment 1 – IRS Private Letter Ruling (PRL)
Attachment 2 – Administrative Services Agreement between the City and PARS
Attachment 3 – Trustee/Investment Management Fee Schedule
Attachment 4 – Resolution for Adoption