Unlocking the Power of Prefunding to Lower Liabilities, Reduce Costs, and Maximize Assets

September 14, 2017
CHARLIE FRANCIS
Former Finance Director, Sausalito
ACTUARIES VS ACCOUNTANTS: THE DUEL!
An actuarial assumption is an estimate of an uncertain variable input into a financial model, normally for the purposes of calculating premiums or benefits. For example, a common actuarial assumption relates to predicting a person's lifespan, given their age, gender, health conditions and other factors.

An accountant monitors and records the actual flow of money through a business or organization. It is the responsibility of the accountant to verify the accuracy of all money transactions and to make sure that all these transactions are legal and follow current guidelines.
PENSION VOLATILITY

- CalPERS UAL is amortized over 30 years (i.e., there is a 30 year plan to pay off the unfunded liability)
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CLOSED POOL
QUESTIONS AN ACTUARY MIGHT ASK...

- Is Prefunding a lower cost for the City than Pay-Go in a sense that a given pension benefit can be provided with a lower contribution rate under funding?

- Is Prefunding more fair from the standpoint of intergenerational redistribution than Pay-Go?

- Is Prefunding better than Pay-Go in signaling future pension costs, and therefore impose greater discipline on pension policy formation?

- Is Prefunding more capable of handling demographic and economic risk than Pay-Go?

- Is Prefunding associated with higher savings (increased capital stock) than Pay-Go?
Where do I find the money?

How do I account for the money?

When can I withdraw the money?

How do I balance the budget?
PENSION VOLATILITY

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CLOSED POOL
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ACTUARIES VS ACCOUNTANTS: HARMONY!
### ACTUARIES VS ACCOUNTANTS: HARMONY!

#### OPEB

1. Close OPEB benefits for all new entrants!
2. Offer to transition current employees from defined benefit OPEB to defined contributions
3. Set up an irrevocable OPEB trust
4. Move income producing capital assets into the irrevocable OPEB trust fund
5. Pay all retiree health care costs out of the irrevocable OPEB trust fund
6. When there are no more PAY-Go annuitants, close the irrevocable OPEB trust fund and return all income producing assets back to the original fund of origin

#### PENSION

1. Set up an irrevocable Pension Trust Fund with Reserves and annual surpluses
2. Annually appropriate deposits to Pension Trust Fund at 100% or higher of annual amortization
3. Advance pay all pension amortization payments out of Pension Trust Funds to take advantage of CalPERS 3.5% prepayment discount.
4. Accumulate balances for
   - Pension Rate Stabilization
   - Pension Investment Return Hedge
KEVIN O’ROURKE
Senior Consultant
Public Agency
Retirement Services

DENNIS YU
Senior Vice President
Public Agency
Retirement Services
CURRENT CLIMATE FOR OPEB FUNDING

- Approximately 80% of Cities offer some type of retiree health care benefits*

- Approximately 50% fund on a pay-as-you-go basis, and 50% pre-fund in some way (reserves/trust)

- Data shows that the total retiree health care liability of $16 billion

- Only $4 billion has been set aside (reserves/trust)

- Only 25% of OPEB liabilities are funded

- Many agencies fund their obligations on a pay-as-you-go basis, often unconcerned or unaware about the future costs they will face.

*Data obtained from League of Cities Study (2015)
IMPACT OF GASB 75

• GASB 75 will replace GASB 45, which had initially changed the way that public agencies recognize their retiree health care liabilities

• Effective FY 2017-2018, public agencies will be required to account for and report their net OPEB liabilities on the balance sheet

• Agencies that do not have an irrevocable trust or are not making sufficient contributions towards their OPEB obligations will face a higher liability

• Change in frequency – regardless of size, an actuarial valuation is required at least every 2 years
DIRECT BENEFITS OF PREFUNDING

• Investing assets results in a greater rate of return which in turn lowers liabilities

• Contributions into an irrevocable trust are “assets” which offset liabilities on financial statements

• Credit rating companies look more favorably on agencies who adopt an Irrevocable Trust and pre-fund
  — A higher credit rating equates to lower borrowing costs

• Lower liabilities gives an agency a chance to keep some form of retiree health benefit; higher liabilities might cause agency to eliminate post-employment benefits
WHY PREFUND?

Retiree Health Care Costs as a Percentage of the Budget

SAMPLE AGENCY

Pay-as-you-Go
Pre-Funding
CURRENT CLIMATE FOR PENSION FUNDING

• Most California pension plans are underfunded (typically between 60-80% funded), resulting in increasing pension contribution rates

• New GASB 68 requirements to disclose Net Pension Liability on financial statements – effective 14/15 FY

• In December 2016, CalPERS lowered the discount rate from 7.5% to 7.0% (with a 3 year phase in)

• Drop in the discount rate puts further pressure on participating member agencies budgets with increasing contribution rates and lower funding ratios
As of June 30, 2015, a Sample City’s CalPERS pension plan is funded as:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actuarial Liability</td>
<td>$699.8 M</td>
</tr>
<tr>
<td>Assets</td>
<td>$453.6 M</td>
</tr>
<tr>
<td>Unfunded Liability</td>
<td>$246.2 M</td>
</tr>
<tr>
<td>Funded Ratio</td>
<td>64.8%</td>
</tr>
<tr>
<td>Employer Contribution Amount (2017-18)</td>
<td>$23.3 M</td>
</tr>
</tbody>
</table>

*Data from Agency’s 2015-16 CalPERS Actuarial Valuation*
Projected misc. contributions increase from $7.9 M to $14.0 M in 6 years
Projected safety contributions increase from $15.4 M to $27.4 M in 6 years.
BACKGROUND

- Previously, the only way to reduce retirement system unfunded liability was to send additional contributions in excess of annual required contribution to pension system.

- As an alternative to sending more money directly to the retirement system, public agencies have setup their own locally controlled Section 115 retirement trust, separate and apart from the retirement system.

- An IRS Private Letter Ruling has affirmed the tax-exempt status of the program.

- More than one hundred (100) CA agencies (including nearly 50 cities) have adopted this program as of August 31, 2017, with many more entities considering adoption.
SECTION 115 TRUST

• Section 115 Trust can be used by local governments to fund essential governmental functions (i.e., retiree healthcare, pension)

• Trust is irrevocable and designed to pre-fund retirement plan obligations

• Assets are considered ‘Fiduciary Funds” that are legally set-aside assets that are available for use to reduce a city’s Net Pension Liability

• Once contributions are placed into trust, assets from the trust can only be used for retirement plan purposes:
  — reimburse agency for Retirement System contributions
  — transferred directly to the Retirement System
  — Pay retirement related expenditures (e.g., actuarial, audit, etc.)
WHY PREFUND PENSION OBLIGATIONS?

1. Complete Local Control over Assets
   City has complete control over contributions and disbursements; timing, amount, and risk tolerance level

2. Pension Rate Stabilization
   Assets can be transferred to retirement system plan at the City’s direction, which can reduce or eliminate large fluctuations in Employer contributions to retirement system

3. Rainy Day Fund
   Emergency source of funds when Employer revenues are impaired based on economic or other conditions

4. Lower Costs
   115 Trust might have lower overall administrative and investment management costs compared to the retirement system
### WHY PREFUND PENSION OBLIGATIONS?

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
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</table>
| **5** | Addresses Pension Liabilities for GASB 68  
Contributions placed in an exclusive benefit trust addresses City’s unfunded pension liability |
| **6** | Improved Credit Ratings  
Rating agencies may look favorably upon actions to reduce liabilities |
| **7** | Actuarially Sound Retirement System  
Provide integrity and security for the source of funding for retirement benefits |
| **8** | Diversified Investing/  
Potential for Greater Return than General Fund  
Can choose risk tolerance level for City’s unique needs |
## Sample Funding Policies

<table>
<thead>
<tr>
<th></th>
<th><strong>Policies</strong></th>
<th><strong>Locations</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Contribute 50% of a given year’s realized year-end surplus to address pension liability</td>
<td>Solana Beach</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Alameda</td>
</tr>
<tr>
<td>2</td>
<td>Contribute amount equal to annual PERS employer contribution ($6 million) in order to allow full access to trust assets at all times</td>
<td>Brea</td>
</tr>
<tr>
<td>3</td>
<td>Contribute $4 million to stabilize PERS employer misc. Rates to 28% and safety rates to 44% through FY 23-24</td>
<td>Healdsburg</td>
</tr>
<tr>
<td>4</td>
<td>“One equals five plan” - Contribute $1 million per year for 5 years based on premise that every contribution will save taxpayers $5 million over 25 years</td>
<td>Huntington Beach</td>
</tr>
</tbody>
</table>
## Sample Funding Policies

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<td>5</td>
<td>Using one-time revenue source plus on-going savings from CalPERS unfunded liability pre-payment</td>
</tr>
<tr>
<td>6</td>
<td>Maintains a 15% general fund reserve and is targeting to make contributions over and above that threshold into the Trust</td>
</tr>
<tr>
<td>7</td>
<td>Earmarked a portion of a recently approved local sales tax measure to be set aside for unfunded pension liabilities</td>
</tr>
</tbody>
</table>
INVESTMENT FLEXIBILITY

• City 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 an Irrevocable Section 115 Trust

• Assets held in an irrevocable trust can be invested per Government Code Section 53216.1 and 53620

• Investments can be diversified and invested in a prudent fashion

• Investments can be tailored to the City’s unique demographics and circumstances

• Increased Risk Diversification
**Investment Strategies**

**PARS Asset Allocation Strategies**

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**Efficient Frontier:**

- **Conservative**
  - Equity: 5-20%
  - Fixed Income: 60-95%
  - Cash: 0-20%

- **Moderately Conservative**
  - Equity: 20-40%
  - Fixed Income: 50-80%
  - Cash: 0-20%

- **Moderate**
  - Equity: 40-60%
  - Fixed Income: 40-60%
  - Cash: 0-20%

- **Balanced**
  - Equity: 50-70%
  - Fixed Income: 30-50%
  - Cash: 0-20%

- **Capital Appreciation**
  - Equity: 65-85%
  - Fixed Income: 10-30%
  - Cash: 0-20%

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**Expected Model Return**

**Expected Model Risk (standard deviation)**
# INVESTMENT STRATEGIES

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Equity (%)</th>
<th>% of Agencies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Money Market</td>
<td>--</td>
<td>2.00%</td>
</tr>
<tr>
<td>Conservative</td>
<td>5-20%</td>
<td>10.00%</td>
</tr>
<tr>
<td>Moderately Conservative</td>
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<tr>
<td>Capital Appreciation</td>
<td>65-85%</td>
<td>5.00%</td>
</tr>
<tr>
<td>Custom Account</td>
<td>--</td>
<td>5.00%</td>
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STEPS TO IMPLEMENTATION

1. Agency adopts resolution to establish trust to address pension liabilities

2. Agency establishes an irrevocable trust and seeks guidance from IRS that proceeds are tax exempt (IRS Private Letter Ruling)

3. Legal Documents (including Plan and Trust Document) are executed

4. Develop investment policy and guidelines for Investment Manager

5. Develop policies and procedures for future annual contributions and/or disbursements

6. Annual Review of Investment Performance
CHRISTINA TURNER
Assistant City Manager, Administrative Services
City of Morgan Hill
In June 2015, Morgan Hill had... approximately $35 million in pension liability (now $51 million)

and

$2.4 million in unfunded OPEB liability (now $3.3 million)

Council directed staff to analyze ways to reduce unfunded liabilities
PRIOR TO PARS

- Morgan Hill did not have OPEB plan
- Funded through pay-as-you-go
- For pension, the other option was to commit additional funds to CalPERS
FUNDING OPTIONS

1. Pay-as-you-Go
2. Earmark Funds
3. Irrevocable Trust Fund
BENEFITS OF IRREVOCABLE TRUST

- GFOA best practices
- Local control
- Improved credit rating
- Reduction of net liabilities
BENEFITS OF IRREVOCABLE TRUST

• Assets are restricted and cannot be used for other purposes
• Used only for contributions/payment
• Transfer to CalPERS to eliminate fluctuations
• Investments options less restricted
WHY MORGAN HILL SELECTED PARS

• Existing relationship with PARS through alternate retirement plans

• Only player in town with IRS private ruling at that time

• Greater local control and efficiency

• Diversify and mitigate CalPERS investment volatility
CURRENT FUNDING - OPEB

- Trustee – US Bank
- $300K/year goal and pay-as-you-go amount
- Balance as of 7/31/17: $1.1 million
- Investment objective – Moderate Strategy
- 1-year annualized return of 10.3%
CURRENT FUNDING – PENSION

- Trustee – US Bank
- $300K/year goal and Annual Required Contribution (ARC)
- Balance as of 7/31/17: $0.8 million
- Investment objective – Moderately Conservative Strategy
- 1-year annualized return of 6.12%
QUESTIONS?