DATE: September 19, 2018

TO: Council Budget and Finance Committee

FROM: Director of Finance

SUBJECT: CalPERS Unfunded Accrued Liability Funding Options

RECOMMENDATION

That the Committee reviews potential funding options for the City to consider for reducing the City's unfunded benefit liabilities and recommends to the City Council a strategy to maximize its resources and reduce unfunded liabilities.

SUMMARY

The City of Hayward, like all cities and municipal agencies, manages unfunded benefit liabilities. An unfunded liability results in the City paying contributions in excess of the normal cost or the employer unfunded accrued liability annual contributions amount. There are four options provided in this staff report to reduce unfunded liabilities: (1) Additional discretionary payments through utilization of otherwise invested City reserves in the form of short-term borrowing or one time payments; (2) creating a section 115 irrevocable pension trust; (3) re-amortizing the current unfunded liability over a shorter period of time; or (4) maintaining the current status quo.

BACKGROUND

The City of Hayward, like all cities and municipal agencies, manages unfunded benefit liabilities as part of its financial picture. Unfunded liabilities are defined as identifiable obligations of an organization for which the organization does not have 100 percent of the funding (cash or other assets) set aside to cover the cost should all obligations become immediately and simultaneously due. Generally, an organization operates based on policies that attempt to find a responsible balance between funding the appropriate portion of these obligations, the associated risk that the unfunded portion of the obligations presents to the organization, and responsible and realistic management of the organization's resources. Achieving this careful balance is considered the practical and responsible approach since payment demands of these obligations rarely, if ever, occur simultaneously.

During recent fiscal years, and at the October 14, 2017 Fiscal Sustainability Work Session, Council continued with its directive for the City to establish a funding plan for all unfunded liabilities. As part of the October 14th Work Session, with Council's recommendations, staff has established a more definitive funding plan for some of the City's unfunded liabilities. On

March 21, 2018, the Council Budget and Finance Committee[1] reviewed and confirmed current policies regarding funding the City's benefit liabilities.

DISCUSSION

The City actively manages its benefit liabilities and completes actuarial valuations for all benefit liabilities except for accrued leave payouts (analysis conducted by staff). These valuations consider the economic, demographic, and historical compositions of the benefit programs and establish amounts that the City should set aside each year to fund its benefit-related financial obligations. It is critical that the City continue to manage and address its benefit liabilities to ensure long-term fiscal stability. Actuarial valuations identify the Annual Required Contribution (ARC) an agency should make toward the funding of the benefit. This is essentially the minimum funding amount that should be responsibly made by any organization. The ARC is generally comprised of two elements: a portion of funding for current costs (sometimes referred to as "pay go") and a portion of funding for future costs (the Unfunded Accrued Liability or UAL).

What is the Unfunded Accrued Liability?

The UAL obligation represents the market value of the assets minus the discounted value of the future liabilities. A different way of saying this is that the UAL is the difference in total City pension financial assets with CalPERS versus present value of future pension benefits accrued and owed in the future by the City. An unfunded liability results in the City paying contributions in excess of the normal cost or the employer UAL annual contributions amount. Because the City has a UAL, CalPERS produces a payment schedule requiring annual payments to reduce the UAL to zero over time (typically 20-30 years). The City's annual UAL contributions payment calculated by CalPERS is designed to pay down the UAL principal amount and interest over that amortization period (currently 28 years).

What causes these Unfunded Obligations?

The UAL is an annual actuarial estimate based on a series of complex economic and demographic assumptions associated with the pension plan's membership. Demographic assumptions include mortality rates, retirement rates, and employment termination rates, among others. Economic assumptions include future investment earnings, inflation, and salary growth rates. The development of a UAL typically results from unfavorable investment returns, changes in actuarial assumptions, unfavorable demographic shifts, and other experiences that differ from those anticipated by the annual actuarial assumptions.

The City's pension plans over the past several decades, like all other CalPERS participants, have experienced unfavorable investment returns, changes in actuarial assumptions, and unfavorable demographic shifts that have outweighed any positive plan experiences. The

[1] **Council Budget and Finance Committee March 21, 2018 Meeting**
https://hayward.legistar.com/LegislationDetail.aspx?ID=3427804&GUID=2A91D510-E4BE-4B6B-9F9F-F1E0C7278A3C&Options=&Search=

table below provides the preliminary Public Employees' Retirement Fund (PERF) Investment returns for the 12-month period that ended June 30, 2018, five years, ten years, and since inception.

CalPERS Investment Return*	2018	5 Years	10 Years	20 Years	PERF Since Inception (1988)
*preliminary	8.6%	8.1%	5.6%	6.1%	8.4%

As bond rating agencies review the City's debt, they actively consider the level of the City's unfunded benefit liabilities and the economic pressure this places on the City. Failure to meet the minimum recommended funding levels or implement a plan to achieve full funding of the ARC and/or a long-term plan to pay down the future liabilities could have a negative impact on future bond ratings – with a possible resultant increase in the cost of borrowing should the City seek to incur new debt or refinance existing debt.

Table 1 provides a summary of the City's benefit liabilities and current levels of funding based on the most recent actuarial valuations. Each of these benefit liabilities is unique in its structure and the degree of funding varies depending on the benefit.

Table 1: Summary of Benefit Liabilities (in millions)

(*in millions*)	Actuarial Valuation Date	Accrued Liability	Value of Assets	Funded Ratio	Unfunded Liability (1)	Unfunded Ratio
CalPERS Police Safety Plan	6/30/2016	$ 354.59	$ 209.91	59.2%	$ 144.68	40.8%
CalPERS Fire Safety Plan	6/30/2016	$ 272.37	$ 166.80	61.2%	$ 105.57	38.8%
CalPERS Miscellaneous Plan	6/30/2016	$ 418.59	$ 268.64	64.2%	$ 149.95	35.8%
Total Cal PERS		**$1,045.55**	**$ 645.36**	**61.5%**	**$ 400.20**	**38.5%**
OPEB - Retiree Medical Police Officers	6/30/2015	$ 55.69	$ 1.36	2.4%	$ 54.33	97.6%
OPEB - Retiree Medical Fightfigters	6/30/2015	$ 22.47	$ 0.94	4.2%	$ 21.53	95.8%
OPEB - Retiree Medical Miscellaneous	6/30/2015	$ 30.18	$ 1.38	4.6%	$ 28.80	95.4%
Total OPEB-Retiree Medical		**$ 108.34**	**$ 3.68**	**3.7%**	**$ 104.66**	**96.3%**
Workers' Compensation	6/30/2017	$ 16.64	$ 8.63	51.9%	$ 8.01	48.1%
Accrued Leave Payouts (1)	6/30/2017	7.89	0	0.0%	$ 7.89	100%
TOTAL		**$1,178.42**	**$ 657.67**	**55.8%**	$ 520.76	**44.2%**

Acceptable or Best Practice levels of funding vary by liability type. In general, most consider an appropriate range of funding would be 75 – 80 percent. Currently, the City of Hayward's CalPERS total unfunded accrued liability is $400.2 Million, or 61.5 funded ratio.

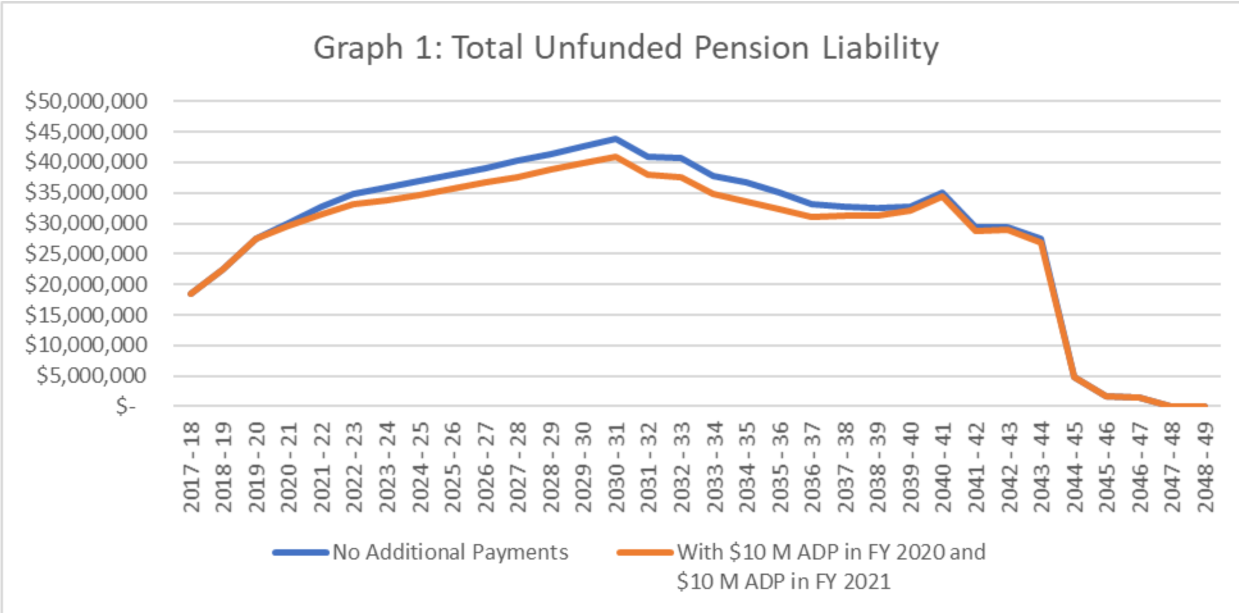
Benefits of Paying Down the Unfunded Accrued Liability

A reduced UAL improves the City's balance sheet, decreases total long-term payments, and increases benefit security for current and former employees. "Accelerated funding" in general means paying down the UAL sooner than the CalPERS standard payment schedule. The following are options for the Committee to consider reducing the City's unfunded accrued liability.

Option 1: Additional Discretionary Payments through Enterprise Fund Borrowing

One mechanism to reduce the City's UAL is to make additional discretionary payments (ADP) either through borrowing from unutilized reserves or making one-time cash payments. The City could borrow using currently unutilized reserves from funds such as the City's enterprise funds and make additional discretionary payments of $10 Million each year in FY 2020 and FY 2021, totaling $20 Million. The City would be borrowing from other City funds and would need to repay these funds at a rate of return that would allow the funds a return similar to or slightly better than that of the City's investment portfolio, but a rate much lower than the funds would project to earn if managed by CalPERS in PERF or a similar tool. The current projections from CalPERS actuaries reflect a total unfunded pension liability of $936 Million through FY 2047. With additional discretionary payments of $10 Million annually in FY 2020 and FY 2021, even with factoring in the cost of repaying the utilized funds at a reasonable interest rate, the projected total cost is $920 Million, reflecting a savings of approximately $16 Million to the City. Attachment II provides a detailed comparison between the projected UAL from CalPERS and the estimated cost of the UAL with the two additional discretionary payments. The net projected savings is subject to additional risk should CalPERS investment returns fail to meet projections.

Status Quo	$10 M ADP in FY 2020 and $10 M ADP in FY 2021, With Payback to Enterprise Funds	Net Projected Savings
$935,530,480	$919,599,235	**$15,931,245**



Accelerated funding demonstrates strong, proactive financial management to rating agencies. Making lump sum payments immediately lowers the UAL and subsequently lowers the payment amounts. In addition, less interest is paid on the UAL balance which lowers annual payment amounts.

***Number of Agencies in California making use of Additional Discretionary Payments*[2]**

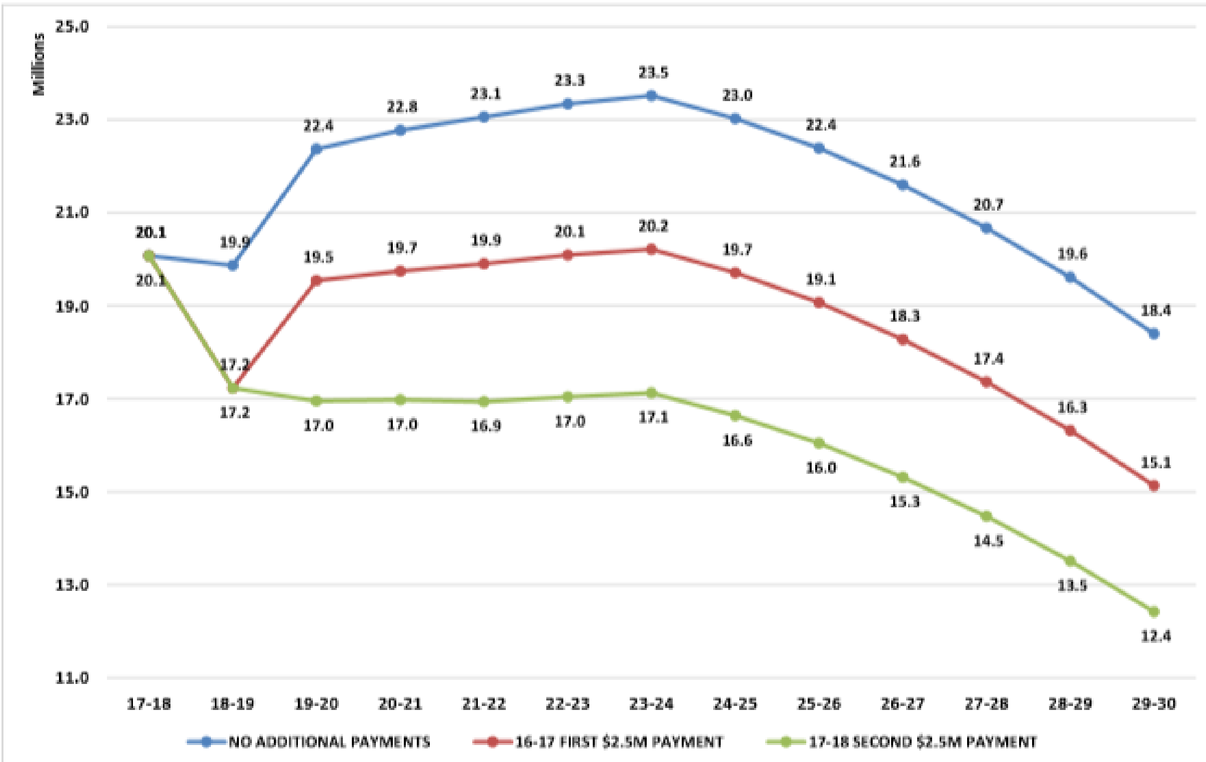
Fiscal Year	Agencies	Total Amount
2016	119	$143,764,000
2017	137	$228,410,000
2018	127	$317,337,000

Example: City of La Palma, CA Made Two $2.5 Million Additional Discretionary Payments

The City of La Palma, located in the greater Los Angeles area, has an annual operating budget of $15.2 Million. The City of La Palma developed a strategy to make two additional discretionary payments of $2.5 Million each in FY 2017 and FY 2018 to pay down their UAL. Making the lump sum payments immediately lowered their UAL and subsequently lowered their payment amounts.

[2] David Dubois (2018), Proactively Managing the Pension Plan's Unfunded Liability, CSMFO Chapter Meeting East Bay/Peninsula Chapter [PowerPoint Slides]. Retrieved from author. Note that FY 2018 reflects 10.5 months of data.

Graph 2: La Palma's Total Unfunded Pension Liability



Graph 3 illustrates how the annual required payments toward UAL are projected to drop significantly with La Palma's additional payments. The reduced ongoing required UAL payments provide enough relief to the City of La Palma's General Fund that they are able to absorb the payments until the costs begin to stabilize in FY 2031 and eventually take a significant drop in FY 2035.

Graph 3: La Palma's Total Unfunded Pension Liability Payments

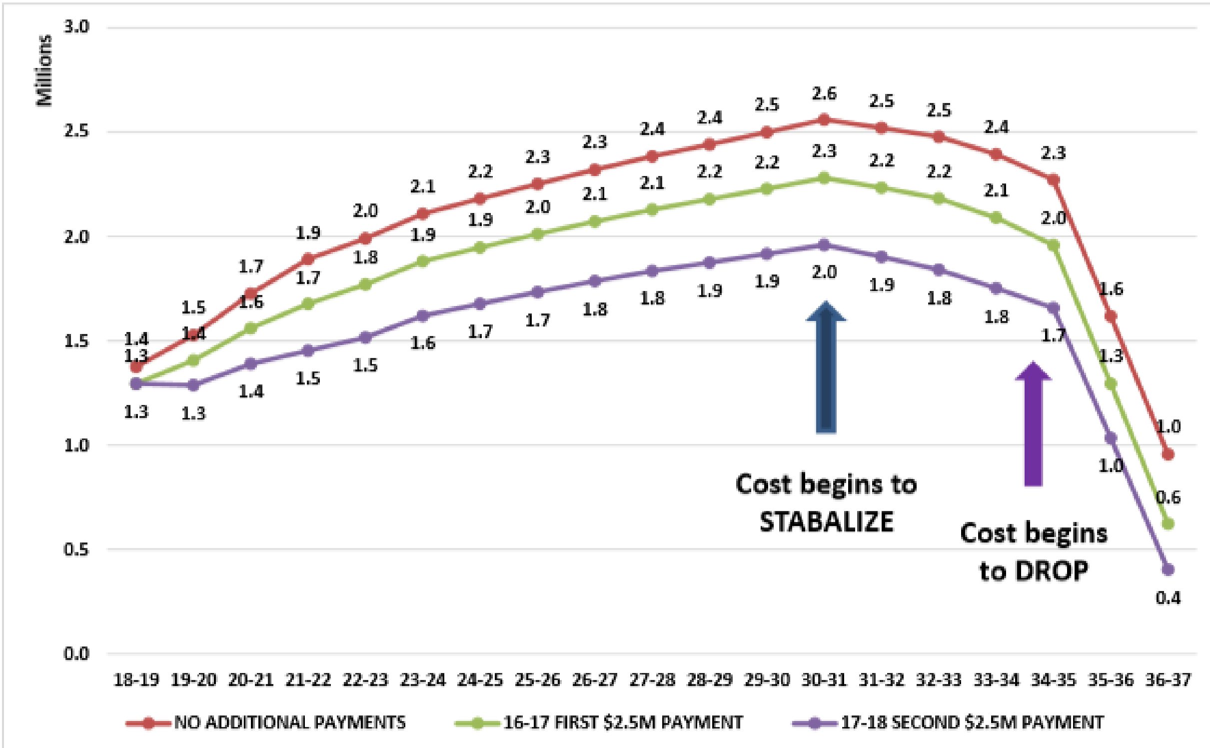


Table 2 provides La Palma's estimated annual cost reduction in UAL payments by making $2.5 million payments in FY 2017 and the second in FY 2018.

Table 2: La Palma's Estimated Total Annual Unfunded Liability Payments

	18-19	19-20	20-21	21-22	22-23	23-24	24-25	25-26	26-27	27-28
NO ADDITIONAL PAYMENTS	1.4M	1.5M	1.7M	1.9M	2.0M	2.1M	2.2M	2.3M	2.4M	2.4M
ADDITIONAL PAYMENTS	1.3M	1.3M	1.4M	1.5M	1.5M	1.6M	1.7M	1.7M	1.8M	1.8M
ANNUAL SAVINGS	80,600	239,300	335,800	437,900	473,800	488,000	502,700	517,800	533,300	549,300

<u>Option 2: Section 115 Irrevocable Pension Trust</u>

Another strategy for the City to consider is funding the unfunded long-term pension liabilities by establishing an Internal Revenue Service Code Section 115 Trust (115 Trust) to hold assets set aside to fund future pension liabilities and expenditures. The objectives of this type of trust are to provide reasonable returns and maximum flexibility of trust assets. The yield objective recognizes the need to protect principal value of the assets in the trust while also acknowledging that yields cannot be obtained without some measure of prudent risk.

The upside of a Section 115 Pension Trust provides more local control and discretion and can decrease investment risk. Any income derived from a 115 Trust is tax exempt. Once contributions are placed into trust, assets from the trust can only be used for retirement plan purposes: (1) reimburse City for retirement system contributions; (2) assets can be transferred to retirement system at any time for pension payments; and (3) paying plan expenses (actuarial valuation or audit). However, the Section 115 Pension Trust does not directly reduce net pension liability, it merely sets aside assets to offset it. A reduction to pension liability can only be done with additional discretionary payments. Further, assets in the trust are not recognized when CalPERS sets contributions rate. There are fees and administration costs associated with a Section 115 Pension Trust. While the performance of these type of funds can exceed that of PERF, they can also be more expensive than the strategy of making use of current City reserves to make additional discretionary payments.

Option 3: Fresh Start

A "fresh start" is a CalPERS term for re-amortizing the current unfunded liability over a shorter period of time. CalPERS will make a new, official UAL payment schedule of higher payments over a shorter term (e.g. 10 or 15 years). The impact of this shortening would be higher annual contributions to the system, which could potentially double from the existing payments in the 10-year scenario. Once directed, the new payment schedule cannot be changed back or altered, other than to further shorten the payment period. The restrictive nature of this option makes it unappealing for the City.

Option 4: Status Quo

The status quo option essentially entails that the City continues to pay down gradually the unfunded liability with the existing rates that CalPERS is charging the City. Under this option, the pay off duration is estimated to be 28 years.

Option 1, Option 2, and Option 3 are not exclusive of each other and some jurisdictions do utilize both mechanisms to reduce their UAL.

NEXT STEPS

Should the Council Budget and Finance Committee recommend pursuing one of these strategies, staff will bring the recommendation to the City Council for further discussion.

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