Item Number: 18

City Council / Board of Directors

Written Communications

Meeting of: July 16, 2024

Submitted By:
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Subject:
Council Policy No. CP-24-02 (Pension Liability Management Policy)

Recommendation:
That the Honorable City Council adopt Council Policy No. CP-24-02, the Pension Liability Management Policy

Fiscal Impact:
There is no fiscal impact associated with adoption of the Pension Liability Management Policy ("Policy"). If adopted, the Policy would serve as a guide for the City in managing its pension liability and is intended to be reviewed annually by staff and Council.

Strategic Plan Goal:
This item aligns with Goal A. Financial Sustainability, Strategy 1 to develop a multi-year plan and strategies to address pension obligations due to increasing pension costs and resulting pressures on the General Fund.

Background:
The City participates in three pension plans – Classic Safety (for Fire employees hired prior to January 1, 2013), Miscellaneous (for Classic and PEPRA Non-Safety employees), and PEPRA Safety (Fire employees hired after January 1, 2013). PEPRA is the California Public Employees' Pension Reform Act of 2013. The California Public Employees' Retirement System ("CalPERS") publishes annual reports in August known as Actuarial Reports; one report for each pension plan. These reports are two fiscal years in arrears. Therefore, the current report is as of June 30, 2022.

Based on the most recent actuarial reports, the PEPRA Safety Fire plan carries a very manageable funding shortfall, or Unfunded Actuarial Liability ("UAL") of $521,390, and annual UAL payments peak at approximately $74,750. The payment peak is the highest payment shown on the Amortization Schedule provided in the report.

Therefore, the Pension Liability Management Policy focuses on the City's Classic Safety and Miscellaneous Plans which have a combined accrued liability of $298.2 million with a market value of assets of $205.7 million, resulting in a UAL of $92.5 million (i.e., a funding ratio of 69%). The City's combined annual UAL payments for the Classic Safety and Miscellaneous Plans are projected to increase from $7.4 million in FY 2023-24 to $10.0 million in FY 2029-30, representing an increase of 35.0% over the next six years.

The City's Issuer Credit Rating ("ICR") from S&P is currently a strong "AA-". S&P noted in its ICR rating report in April 2021 that, while they view the City's pension and Other Post-Employment Benefits ("OPEB") liabilities as manageable, the rising costs related to the City's underfunded pension liabilities may exacerbate budgetary pressures over the longer term. In its continued surveillance of the City's ICR, S&P will continue to evaluate the City's pension liabilities as part of its "debt and contingent liabilities" metric and consider whether a pension liability management policy has been adopted as part of its "management policies and practices" metric. Adopting the Pension Liability Management Policy helps to support factors for maintaining the City's "AA-" rating.

Discussion:

In order to address the City's pension liabilities and take advantage of opportunities to lower the UAL through various strategies, staff have worked with a Municipal Advisor (Urban Futures, Inc.) to develop a Pension Liability Management Policy for Council's consideration and adoption.

The attached Policy incudes: 1) Policy objectives and goals; 2) A description of the City's pension plans and liabilities; 3) Strategies for managing the City's pension liabilities; 4) Potential funding sources for these strategies; 5) Reserve and funding target levels; and 6) Policy review and amendment.

The Policy provides a guideline for the City in implementing a long-term plan that utilizes multiple strategies over time. For example, if the Policy is adopted, staff will monitor opportunities to manage the City's UAL through the following strategies:

(1) **Additional Discretionary Payments ("ADPs") to CalPERS** - Payments above and beyond the annually required contributions to CalPERS in order to prepay a portion of the UAL, resulting in savings over time.

(2) **Section 115 Trust** - Trust assets can only be used to pay employer pension obligations (including normal costs) and allows the City to build a pension reserve that has greater investment flexibility and risk diversification compared to the City's investment portfolio.

(3) **Pension Stabilization Reserve Fund** – A rainy-day fund to meet pension obligations when revenues are impaired based on economic or other conditions.

Moneys in this reserve fund are subject to California Government Code investment restrictions and the City's Investment Policy. The current Reserve Fund target is recommended at $2.6 million, which represents the increase in annual UAL payments for the Miscellaneous and Safety Plans from FY 2023-24 to FY 2029-30 (the current anticipated peak year).

(4) **Accelerating Payment of New Amortization Bases** - Accelerate the repayment of new Amortization Bases added to the UAL.

Potential funding sources for the above strategies include:

(1) **Reserves in Excess of Policy Targets** - To the extent that the City has reserves in its General Fund or other funds in excess of reserve targets, the City may consider allocating all or a portion of the excess toward the UAL.

(2) **Operating Surplus** - On a case-by-case basis, staff may recommend that 50% of the remaining operating surpluses (after considerations of deficits, reserve deficiencies and other fiscal matters), up to $1 million, be used to address the UAL.

(3) **Debt Service Savings from Refinancings** - When issuing refunding bonds for savings, the City can set aside all or a portion of debt service savings to address the UAL.

(4) **Savings from Annual Prepayment Option to CalPERS** - Each year, CalPERS gives its member agencies an option to make a lower (approximately 3% savings) lump sum payment for the entire year's required contribution by July 31st. The City can continue to make the prepayment every July to CalPERS and set aside the savings to address the UAL.

(5) **Financing Strategies** - Tax-Exempt Exchange and Pension Obligation Bonds.

Although the Policy discusses Pension Obligation Bonds ("POBs") and provides guidelines for the potential issuance of POBs, current market dynamics eliminate POBs as an economical option. Therefore, staff are not recommending that the Council consider this as a viable strategy at this point. However, staff recommend including the guidelines in the Policy should a market opportunity return, and the Council is interested in exploring POBs.

While the ultimate goal is to have pension liabilities fully or mostly funded, the City's intermediate goal is to have its pension liabilities to be 80% funded. The funded status goal may be achieved over a period of several years. The funding level is expected to fluctuate; however, it should not fall below 70%, unless it is due to factors out of the City's control (i.e., unanticipated investment earnings far below CalPERS' investment target in a given year). The City should anticipate that its UAL will change over time and CalPERS investment results will vary. Therefore, it should expect to "actively manage" this liability and make adjustments to the Policy as the landscape changes. Staff recommend reviewing this Policy annually as part of its Mid-Year Budget Review process.

Staff remain available for any questions the Council may have.

Attachments: A. Pension Liability Management Policy