Agenda Item No. 5.B.

City of El Cerrito

CalPERS Pension Costs Update

Introduction to Cost Management and Alternative Repayment Strategies

The City of El Cerrito

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March 2, 2021

Executive Summary of Presentation

- City of El Cerrito has a projected $70.3M Unfunded Accrued Liability (UAL) for 6/30/2021 with CalPERS
  - 70% increase (from $41.4M) over last 7 years
  - Annual UAL payments (UAL) projected to grow from $4.9M (2021) to $6.9M (2026)
- Other City debt liabilities
  - $3.9M of Other Post-Employment Benefits (OPEB) net liability (6/30/2019)
  - $23.3M of COPs, sales taxes revenue bonds, tax and revenue anticipation notes and leases
- Rapidly increasing (and uneven) repayment shape of UAL is causing added pressure on City's budget
- Planning for, and evaluating options to manage these rising costs are important for budget predictability and fiscal health
  - Cost management strategies - Section 115 Trust, UAL Pay Down and UAL Restructuring

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I. Background on CALPERS Costs

CalPERS Pension 101

Retirement Plan Overview

- City has 2 primary CalPERS plans
  - **Miscellaneous: 428 covered members** including 108 active
  - **Safety: 267 covered members** including 71 active
- Plans include Classic (hired prior to 2013) employees and PEPRA Plans

MISCELLANEOUS PLANS			SAFETY PLANS		
Benefit Group	**# of Actives**	**Benefit Formula**	**Benefit Group**	**# of Actives**	**Benefit Formula**
Miscellaneous	63	2.7% @ 55	Safety	44	3% @ 50
PEPRA Miscellaneous	45	2% @ 62	PEPRA Safety Fire	8	2.7% @ 57
			PEPRA Safety Police	19	2.7% @ 57
Total	**108**	**-**	**Total**	**71**	**-**

CalPERS Pension 101

Payments Made to CalPERS Annually

- Each year, the City makes two types of payments to PERS:
  - **Normal Cost (NC)** = Annual cost for current employees
  - **Unfunded Accrued Liability (UAL):** Actuarial Liability MINUS Actuarial Value of Assets
    - "How much we currently have vs. how much we need to have in the future when people actually retire"
    - Shortfall not repaid all at once; amortized over a longer period of time with the City paying down a portion each year (principal and interest)
      - CalPERS currently amortizes this debt at a rate of 7%
      - Various components (layers or bases) of the UAL with amortization periods ranging from 1 to 29 years

Why CalPERS Costs are Trending Higher

Historical PERS Returns
5-Year: 6.3%
10-Year: 8.5%
20-Year: 5.5%
30-Year: 8.0%

Then …

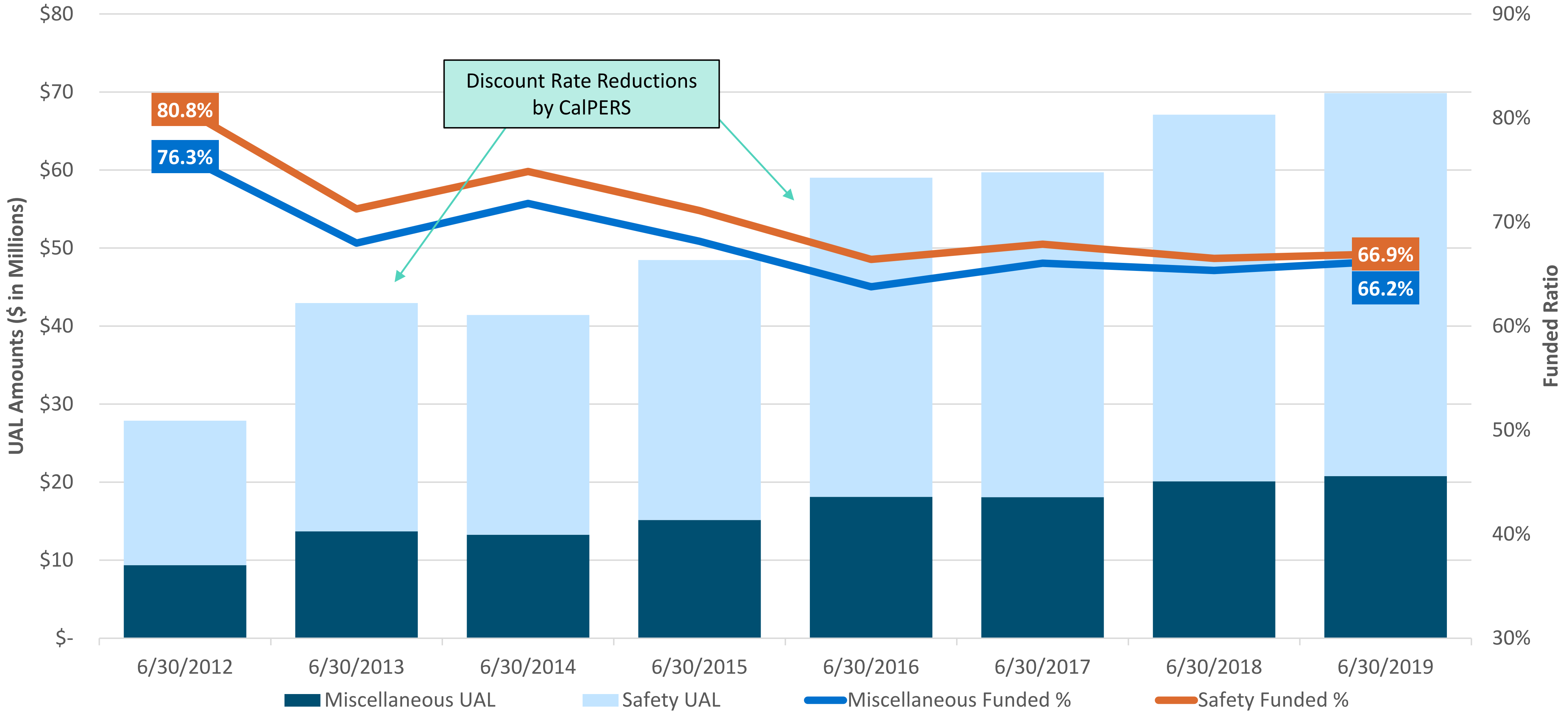
- PERS investment returns were robust (10%+)
  - Retirement plans were "Super-Funded" through the 1990s
  - Earnings on funds were more than adequate to cover retirement costs
- Super-funded status induced widespread retirement benefits enhancements

Now …

- Sluggish investment growth (<6%)
- Assumptions are changing
  - Expected returns: 8.25% → 7.75% in 2003; 7.75% → 7.50% in 2013 → 7.00% by 2020
  - Mortality rates (people living longer)
  - Actuarial Valuation → Market Valuation
- Unfunded liabilities are rapidly growing
  - City's Miscellaneous Plan UAL has grown from **$13.3M to $20.7M over last 7 years**
  - City's Safety Plans' UAL has grown from **$28.2M to $49.6M over last 7 years**

II. Historical and Projected Costs

Historical Growth in Unfunded Accrued Liability (UAL)



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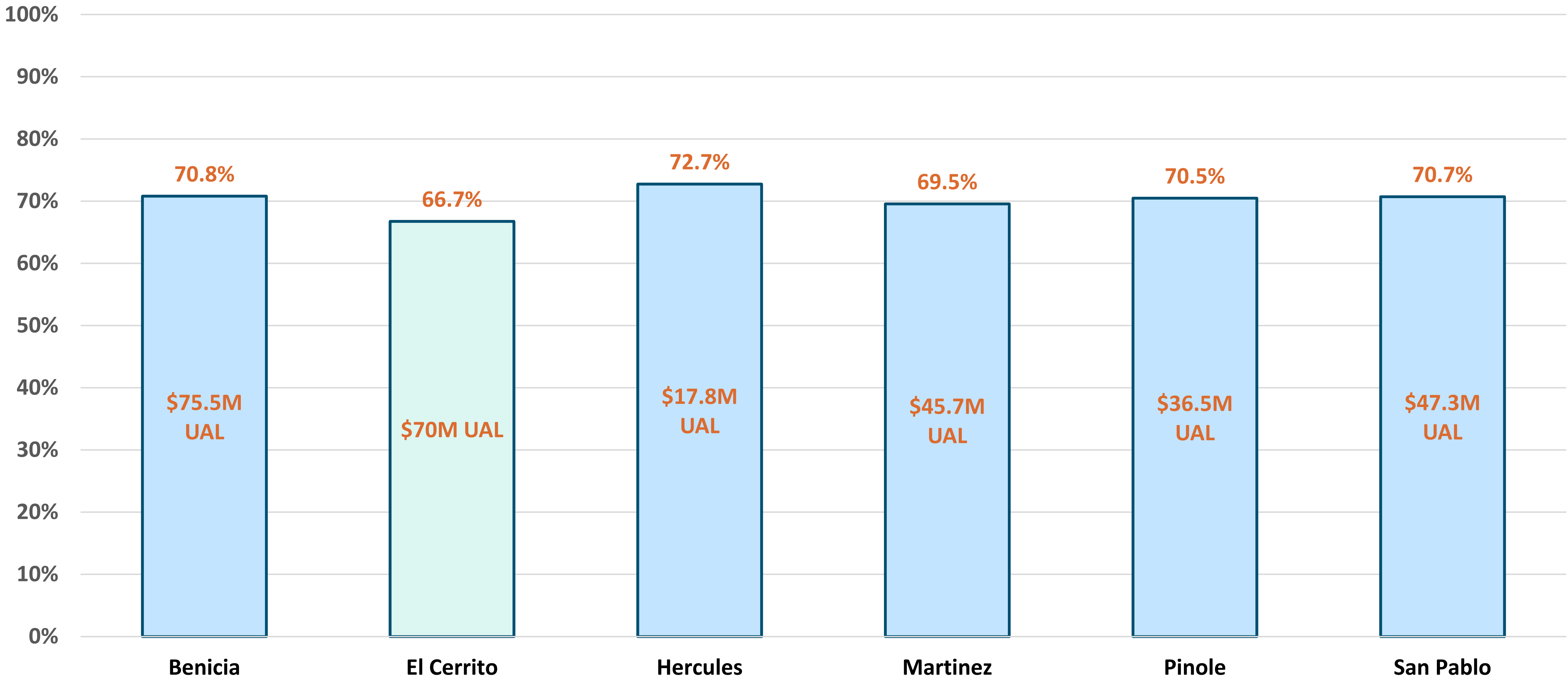
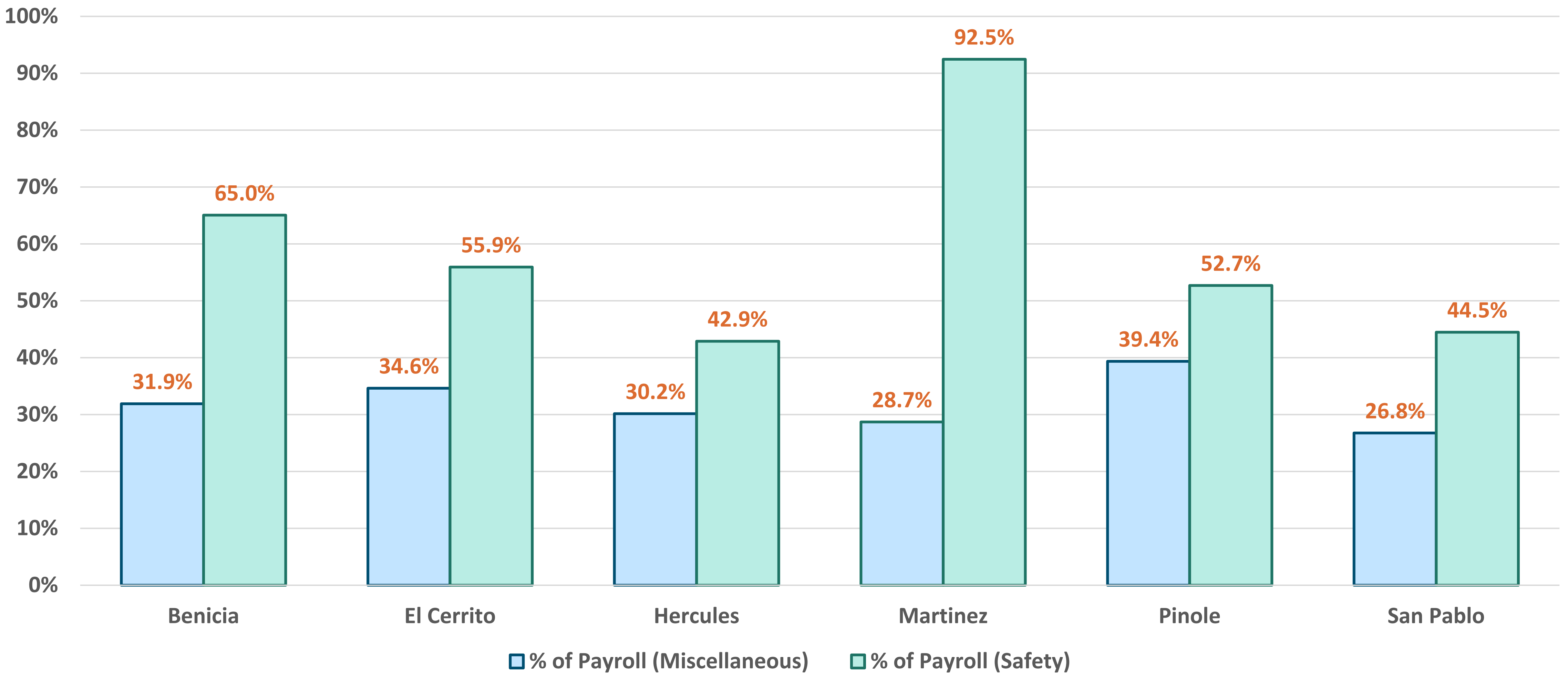
Neighboring Cities: Funded Status (Total Plans)



Source: CalPERS Actuarial Valuation Reports (6/30/2019)

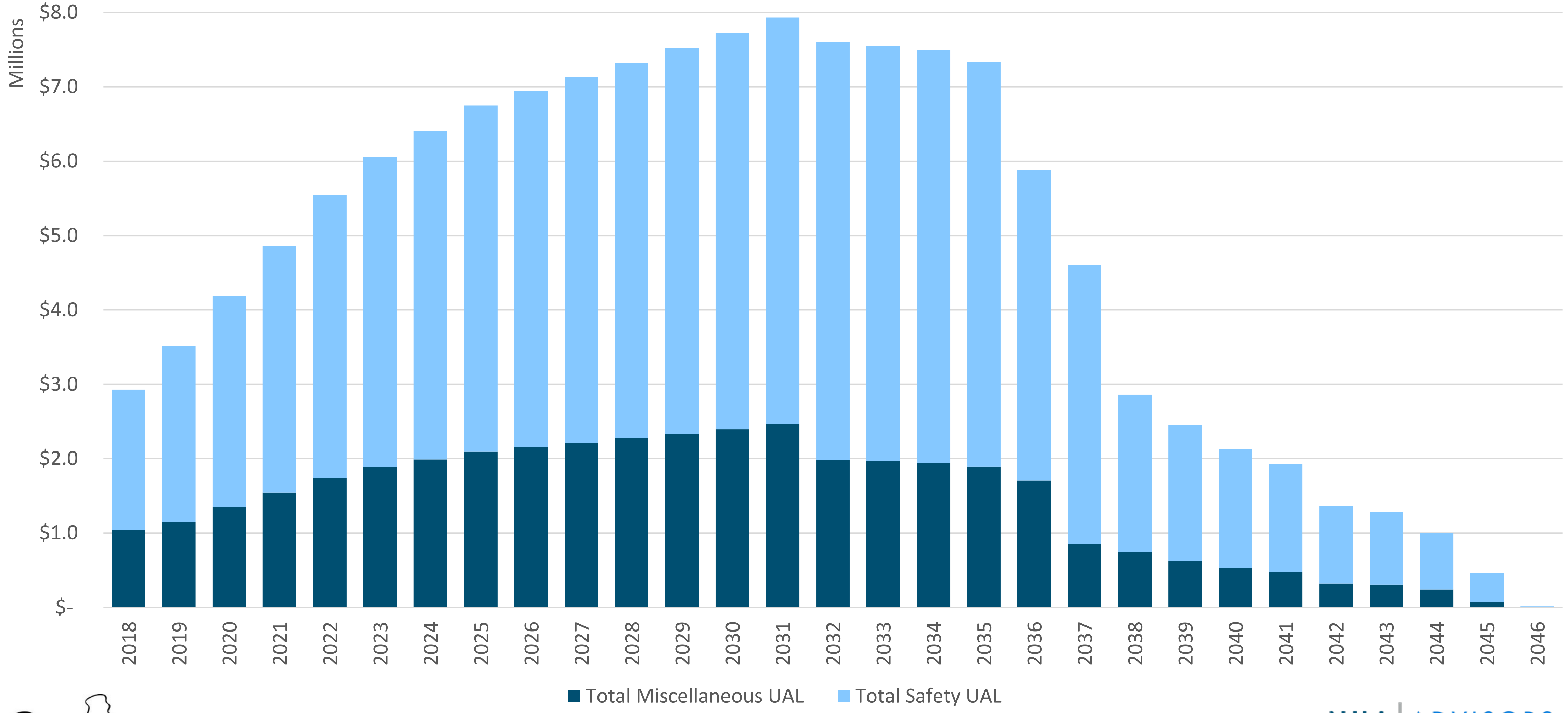
Neighboring Cities: FY 2022 Pension Costs as % of Payroll



Source: CalPERS Actuarial Valuation Reports (6/30/2019)

CalPERS Historical & Projected UAL Payment Schedule

$70.3M Unfunded Accrued Liability (UAL) @ 7% Interest Rate



III. Potential Cost Management Strategies

Potential Strategies to Address Rising Pension Costs

Prepay Annual UAL Payment

- 3.4% discount for paying in beginning of Fiscal Year
- $165,000 savings for FY 2021
- City implements this strategy

Recommended

Fresh Start Amortization

- Pros: Shortens repayment period; reduces overall interest paid
- Cons: New structure "locked-in" + increased annual payments in near term

Not Recommended (see next slide)

Use Cash Reserves to:

- **Set-Up Section 115 Trust** - Separate trust solely dedicated to pension/OPEB
- **Lump Sum Direct Pay Down of UAL** – Reduce UAL with PERS and annual payments

Recommended If Feasible (using Surplus Reserves/ Revenue)

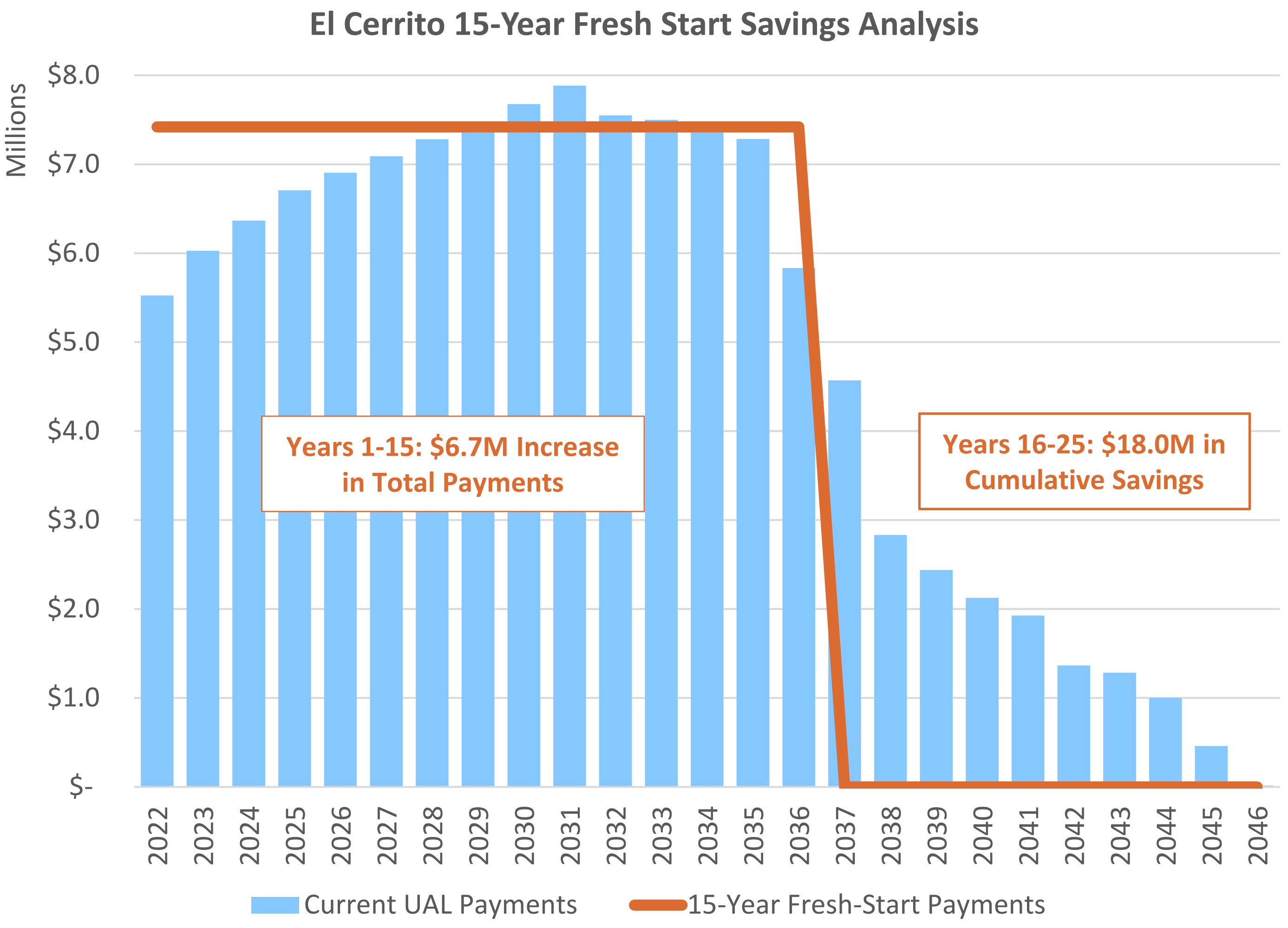
Debt/Bonds

- Pension Obligation Bond (POB) – use bond proceeds to reduce CalPERS UAL
- Restructure payments for enhanced payment smoothing

? Further analysis could be done if requested

Fresh Start Amortization

- City can request new amortization schedule with CalPERS
  - Still amortized at 7%; Must be shorter than current schedule
    - Near term payments are higher, interest savings taken in later years
  - Schedule is "locked-in" and City can't go back to old schedule
    - Due to lack of flexibility, this strategy is not commonly utilized – City could effectuate the same results using either the ADP or Section 115 strategy while maintaining some flexibility



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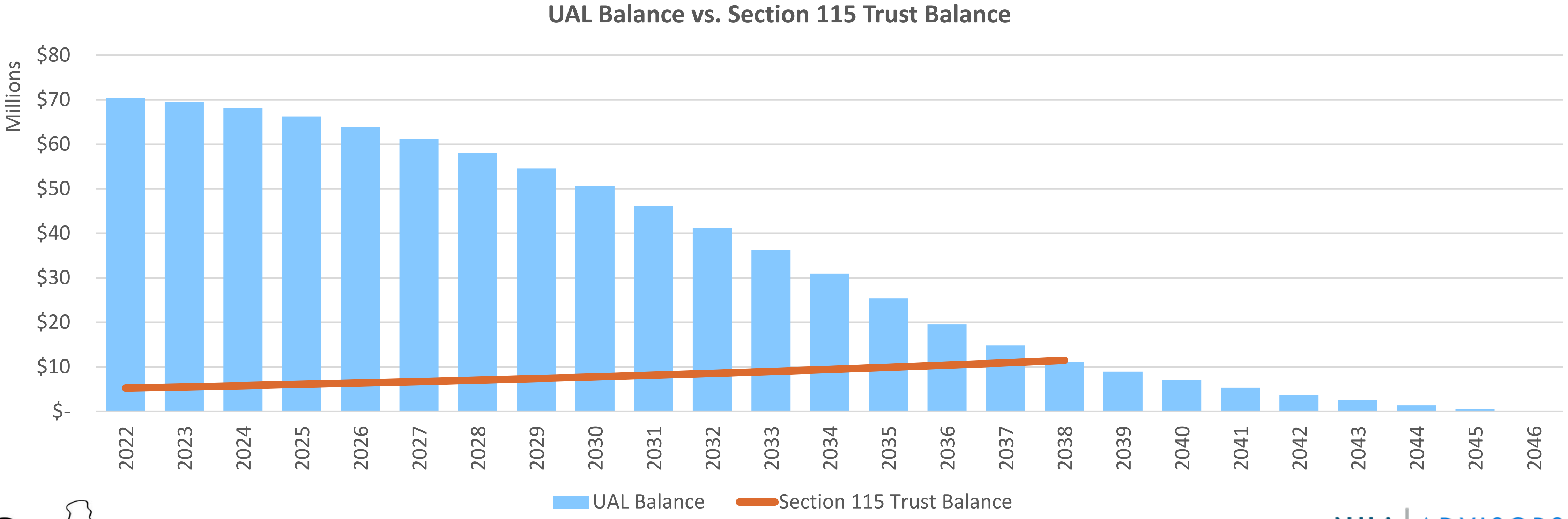
Applying Reserve Funds/Annual Surplus

Option 1: Section 115 Trust

- **What is it? -** Separate trust managed by 3rd party (typically not CalPERS)
  - Dedicated to pension and/or OPEB costs
- **Benefits**
  - Potential for increased investment returns vs. current GF reserves
  - Flexibility – more investment options than CalPERS and can decide when and how to use
    - <u>Longer-Term</u>: Can grow over time and pay off full UAL in the future
    - <u>Shorter-Term</u>: Apply during challenging budget years or to “smooth” payment spikes
  - Diversify assets under management away from CalPERS
- The Trust will show up as an asset on the City’s financial statements, but will not technically offset UAL until funds are transferred to CalPERS

Section 115 Trust – Hypothetical Example

- Assuming **$5M is invested in FY 2022 @ 5.0% returns**, fund's growth would cover UAL balance in 2038 (UAL could be fully paid off), saving $10.6M in UAL payments from FY 2039-2046
- Section 115 Trust funds could also be used to make Normal Contributions to CalPERS during challenging budget years



Applying Reserve Funds/Annual Surplus

Option 2: ADP – Additional Discretionary Payment

- **What is it?** – City makes Additional Discretionary Payment (ADP) to CalPERS and applies funds to a selected amortization base (layer of UAL)
  - CalPERS will eliminate payments associated with the portion of the UAL paid off, essentially giving the City credit at 7% interest
  - While credit is given at 7% interest, the true benefit of the pay down will be based on CalPERS actual returns on those funds in the future
- **Benefits**
  - Reduced UAL with CalPERS and associated payments
  - Opportunity for increased investment returns vs. current GF reserves
  - Higher funding ratios
- **Example** – $5.0M pay down applied to a 20-year UAL base
  - $9.66M of total reduced payments ($4.66M savings net of initial deposit)
  - $483K annual average reduction in payment

Reduced Payments from $5.0 Million Pay Down	
Fiscal Year	20 Year Amortization Base
2023	373,561
2024	383,367
2025	393,430
2026	403,758
2027	414,357
2028	425,234
2029	436,396
2030	447,851
2031	459,607
2032	471,672
2033	484,053
2034	496,760
2035	509,800
2036	523,182
2037	536,916
2038	551,010
2039	565,474
2040	580,317
2041	595,551
2042	611,184
Reduced Payments	**9,663,479**
Initial Deposit	(5,000,000)
Net Savings	**4,663,479**

Estimated payments assume a 7.00% Discount Rate and 2.625% Annual Payroll Growth.

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Section 115 vs. CalPERS ADP Comparison

OPTION	Section 115 Trust	Direct UAL Pay Down with CalPERS
Reduced UAL & UAL Payments with CalPERS	No	Yes
Reduced Pension Liability in CAFR	No (but will be off-setting asset on balance sheet)	Yes
Control of Investment Strategy	Yes	No
Funds Managed By	Trust Administrator	CalPERS
Flexibility in Uses	Yes (annual expenses, direct UAL pay down, OPEB, etc.	No
Savings	Varies; Depends on when City utilizes funds to pay liabilities	Immediate; Length of time varies based on which amortization component is paid off (City's amortization bases currently range from 1-29 years)
Enhanced Budgetary Flexibility	Yes	No
How Many Agencies in CA Have Used?	**231 Agencies currently w/PARS** (111 cities); Several others using other Non-PARS Trust Administrators	168 Different Employers for **431 distinct ADPs in 2020**

III. UAL Restructuring Concept & Strategy

Restructuring UAL Obligation – Conceptual Overview

- City borrows funds (bond proceeds) to make payment to CalPERS for all or a portion of its UAL
  - Typical method is through a Pension Obligation Bond (POB) issued to investors
- Interest rate paid on the new debt would be significantly lower than the 7% charged by CalPERS on UAL obligation (currently 3.0 to 3.5%)
  - Public agencies use a POB to also restructure repayment schedule to meet cash flow objectives and create a more sustainable/predictable repayment shape
- Primary consideration is **re-investment/market timing risk**

Partial List of Recent UAL Restructuring Bonds

Record Low Taxable Interest Rates Have Resulted in Increased Issuance

- Interest rates have ranged from 2.54% to 3.75% for recent pension bonds
  - Dependent on credit rating, market conditions, term
- Spreads to taxable Treasury rates have lowered significantly in recent months, resulting in 2.54% to 2.85% interest rates for 4 most recent transactions
  - "AA" Chula Vista POB priced February 11th lowest pension bond rate in recent history (2.54% for 24-year maturity)

Chula Vista	Downey	Monterey Park*	El Cajon	Ukiah	Coachella	Gardena	Arcadia	Placentia
(2021)	(2021)	(2021)	(2021)	(2020)	(2020)	(2020)	(2020)	(2020)
$350,090,000	$113,580,000	$106,335,000	$147,210,000	$49,875,000	$17,590,000	$100,590,000	$90,000,000	$52,950,000
AA	AA	AA	AA	A+	AA-	AA-	AAA	BBB+

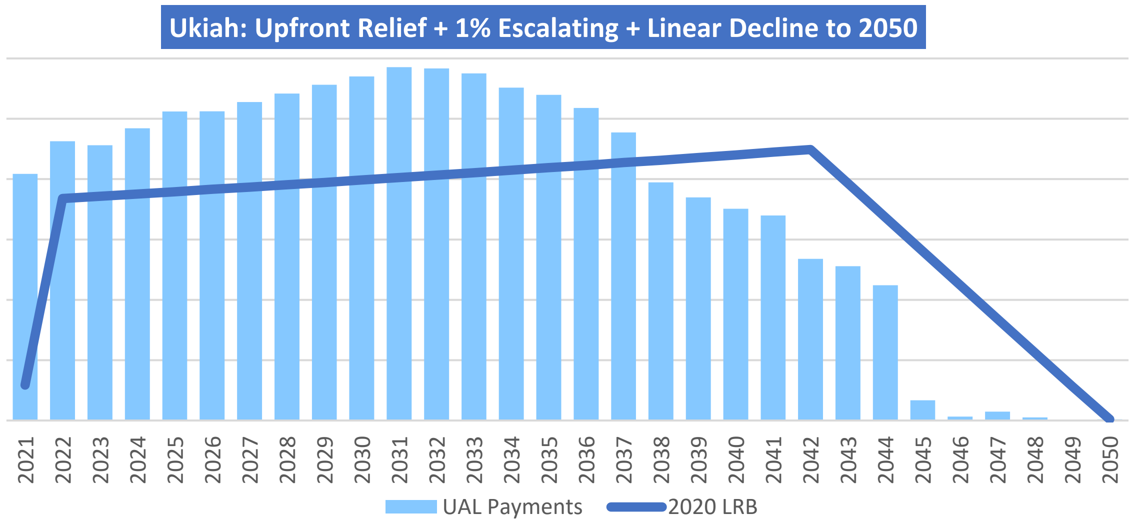
Torrance	Novato Sanitary District	Azusa	Borrego Springs FPD	Pomona	West Covina	Grass Valley	North County Fire Protection District	Kensington Police Protection CSD
(2020)	(2020)	(2020)	(2020)	(2020)	(2020)	(2020)	(2020)	(2020)
$349,515,000	$6,467,000	$70,075,000	$1,874,111	$219,890,000	$204,095,000	$18,311,000	$20,305,000	$4,544,000
AA	Private Placement	AA-	Private Placement	AA-	A+	Private Placement	AA-	Private Placement

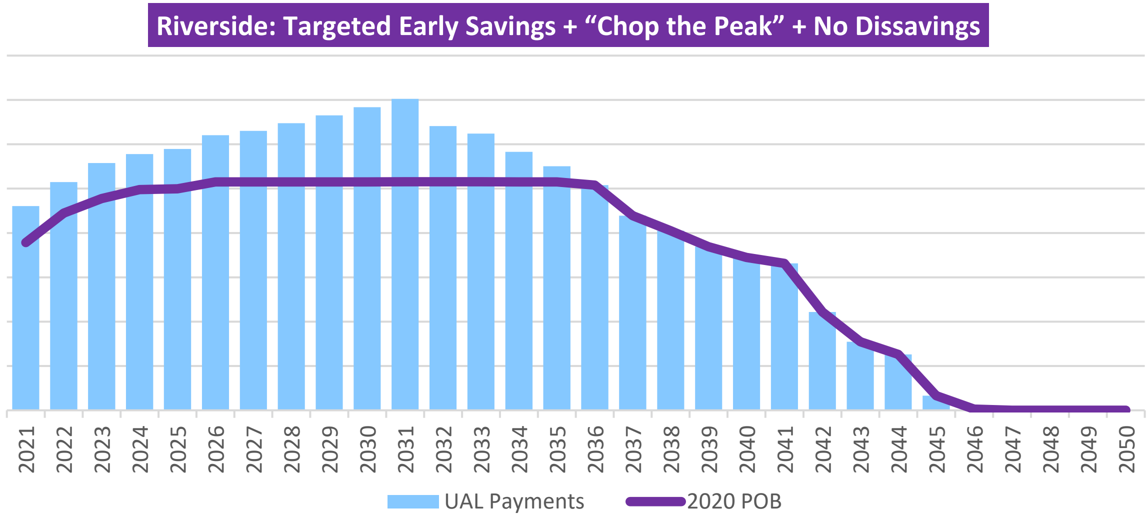
Carson	El Monte*	Riverside	Inglewood*	Montebello*	Ontario	Larkspur	Riverside County	Pasadena
(2020)	(2020)	(2020)	(2020)	(2020)	(2020)	(2020)	(2020)	(2020)
$108,020,000	$118,725,000	$432,165,000	$101,620,000	$153,425,000	$236,585,000	$18,295,000	$719,995,000	$131,805,000
AA-	A+ (Ins.)	AA	AA- (Ins.)	A+ (Ins.)	AA	AAA	AA	AAA

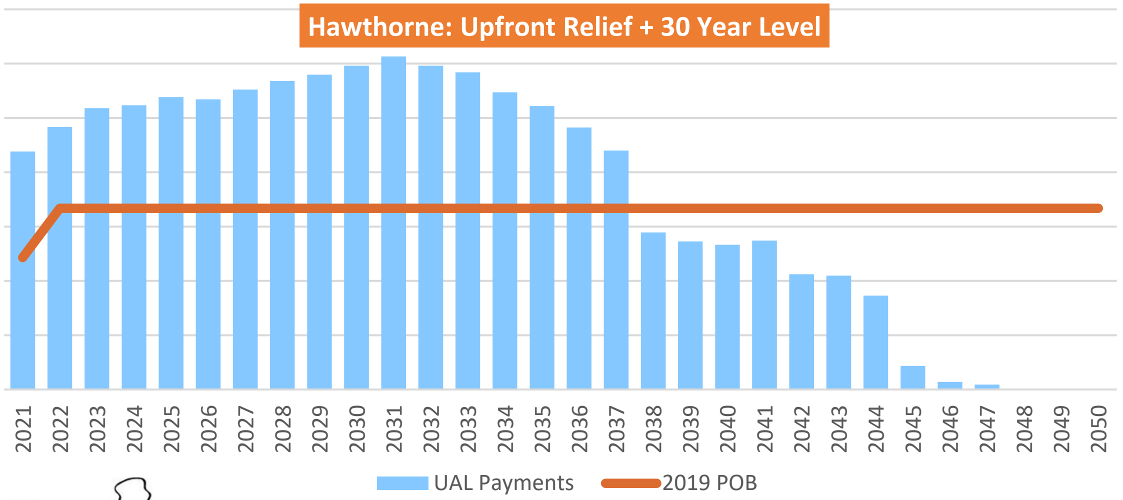
* Secured by pension tax override

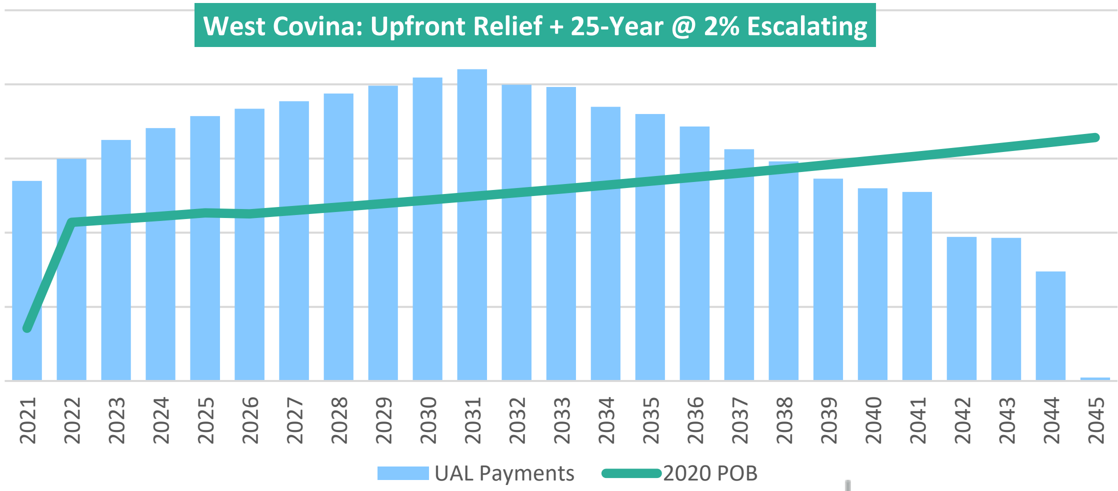
Recent Issuances: Restructuring for Smoothing is a Common Strategy

No One Size Fits All: *Term and Shape of Repayment Unique to Each Issuer*









Pension Bonds - Benefits and Risks

Primary Benefits

- Fiscal Sustainability Tool: Ability to "re-shape" the City's pension debt payments
- Near-Term Budgetary Savings
- Interest Rate Savings "Arbitrage": City can borrow at rates much lower (currently ≈ 3.5% – 4.0%) than those CalPERS is charging on UAL debt (7%)
- Increase Funding Ratio
- Flexibility to Modify Maturity

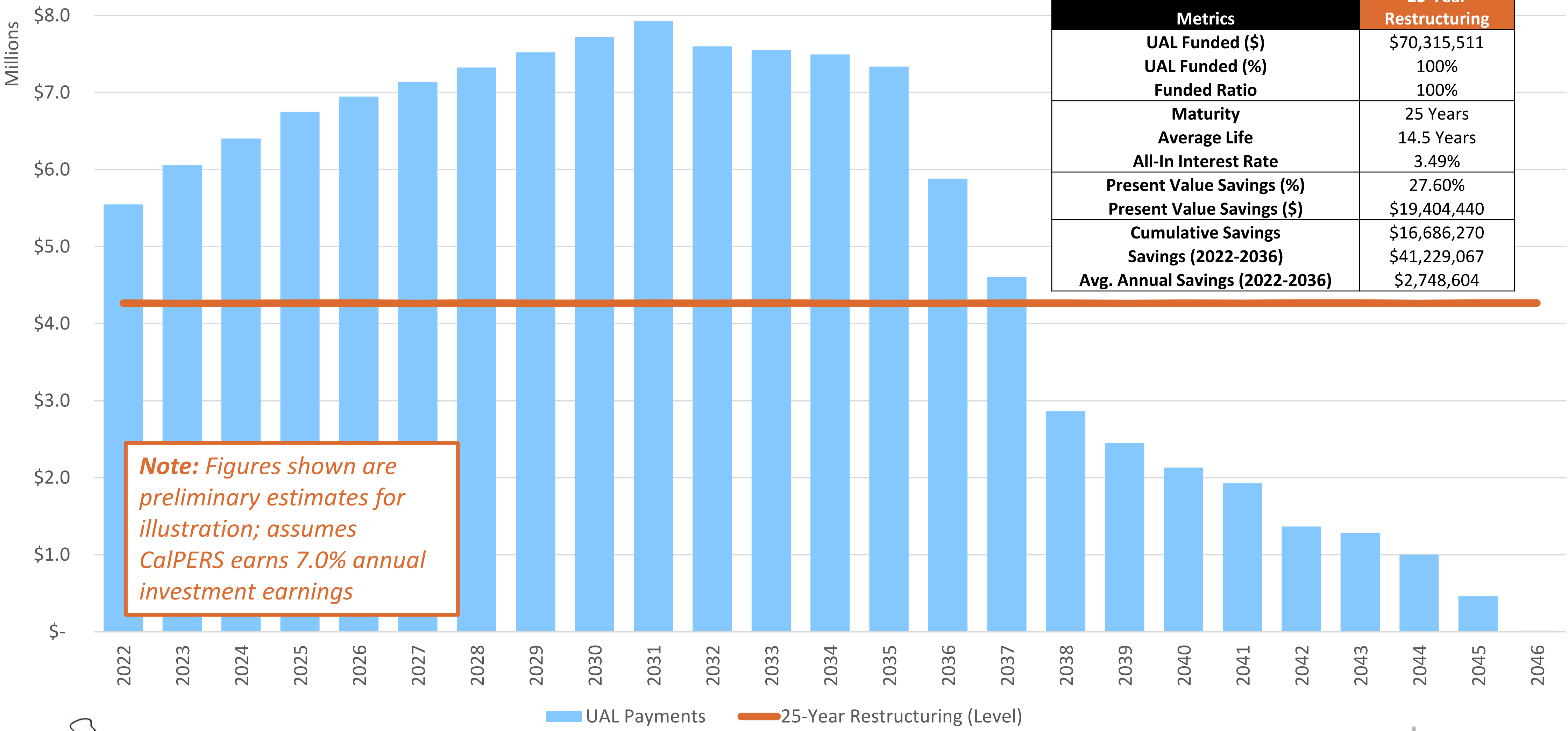
Primary Risk: *Reinvestment & Market Timing Risk*

- Savings is ultimately dependent on future CalPERS returns, which are unknown at time of issuance (primary concern of GFOA)
- Present value savings occur if PERS earns greater returns than pension bond interest rate
- Near-term losses exacerbate this risk given large lump sum deposit into the market

These risks should be quantified through a ***stress testing process*** *to better understand the impacts of future poor investment performance by CalPERS (i.e. What if PERS only earns 5%? What if there is another 2008 Recession?)*

Base Case Preliminary Analysis for El Cerrito

100% UAL Funding Scenario: 25-Year Restructuring to Level Payments



Metrics	25-Year Restructuring
UAL Funded ($)	$70,315,511
UAL Funded (%)	100%
Funded Ratio	100%
Maturity	25 Years
Average Life	14.5 Years
All-In Interest Rate	3.49%
Present Value Savings (%)	27.60%
Present Value Savings ($)	$19,404,440
Cumulative Savings	$16,686,270
Savings (2022-2036)	$41,229,067
Avg. Annual Savings (2022-2036)	$2,748,604

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IV. Conclusion and Next Steps

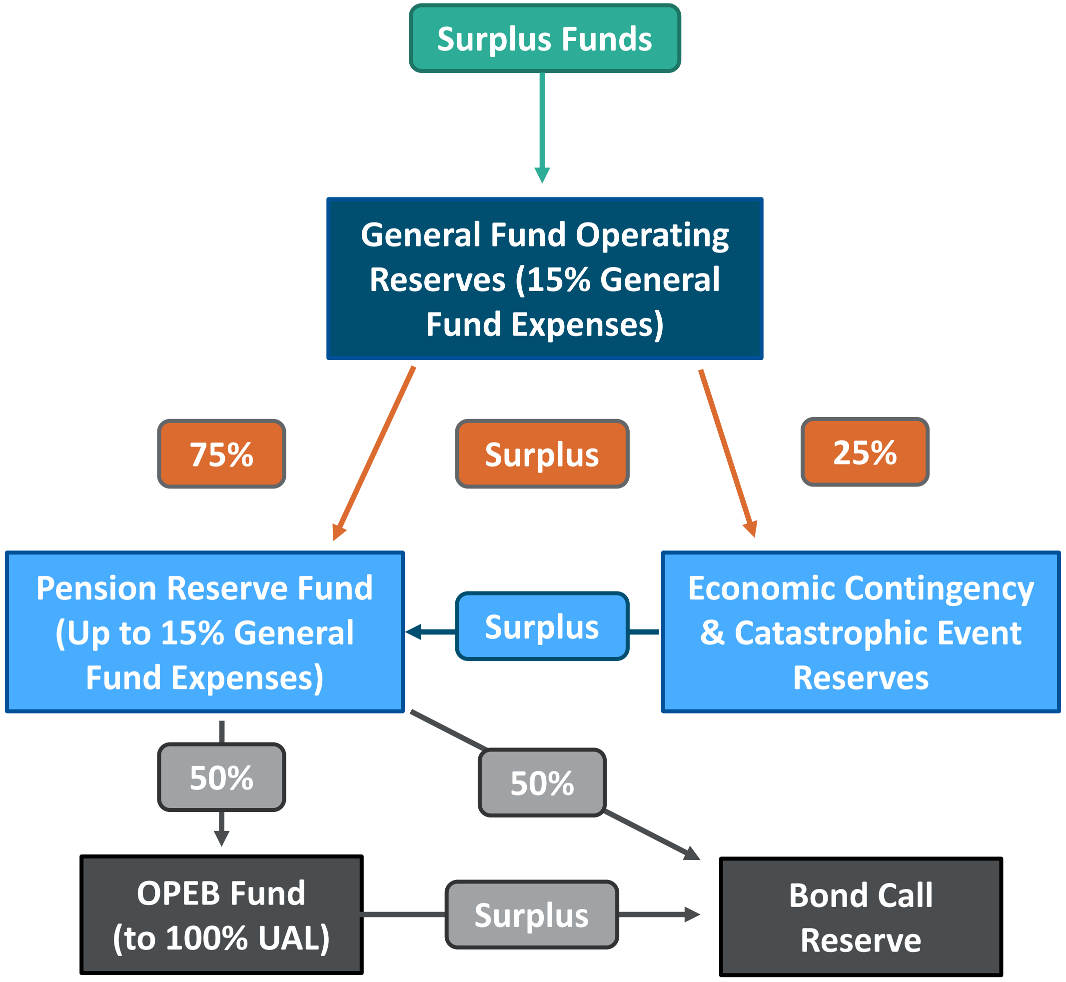
Conclusion and Potential Next Steps

- Rising pension costs are a challenge facing most public agencies
- City should incorporate projected cost increases into budget and planning process
- City can consider various cost management strategies, including:
  - Cash reserves for Section 115 Trust or UAL pay down
  - UAL Restructuring
  - Optimize service levels given projected resources
  - Reviewing 5 – 10-year General Fund forecast may be helpful to identify feasibility and objectives/constraints for these options
- Explore new pension funding policy; Policy could provide guidance related to:
  - Targeted funding ratios
  - How to apply (1) one-time monies; (2) surplus annual revenue towards pension liabilities; (3) savings from a POB
    - Methodology for allocating these funds between 115 Trust and Additional Discretionary Deposit with CalPERS

Appendix: Sample Pension Funding Policy

Example of a Reserve/Pension Funding Policy

- Graphic to right is a conceptual example of another City's Reserve Policy that provides framework around use of annual surplus
- Provides funding mechanism and flow of funds priority for 6 distinct reserves / funds, including Section 115 (pension/OPEB) and a fund to pay down bond debt early



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