



AGENCY: Finance & Admin
MEETING DATE: June 8, 2022
DEPARTMENT: Finance
PRESENTED BY: Isaac Whippy
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AGENDA ITEM SUMMARY

TITLE:

RECEIVE REPORT AND MAKE RECOMMENDATION TO THE CITY COUNCIL ON THE ESTABLISHMENT OF A SECTION 115 TRUST WITH PUBLIC AGENCY RETIREMENT SERVICES (PARS) FOR THE PURPOSE OF PRE-FUNDING THE CITY'S FUTURE UNFUNDED LIABILITY WITH CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (CALPERS)

ISSUE:

The Finance & Admin Committee is being asked to approve and make a recommendation for establishing a third-party irrevocable trust to pre-fund a portion of the City's long-term financial pension obligation. Approval of a Trust implements one of the strategies included in the Council Adopted Pension Funding Policy and is a recognized best practice that will help the City achieve greater financial sustainability.

ANALYSIS:

The City of Fort Bragg has two defined benefit pension plans with the California Public Employees' Retirement System (CalPERS) - one Miscellaneous Plan and one Safety Plan (Police and Fire).

All qualified permanent and probationary employees are eligible to participate in the pension plan for which they are eligible members based on their employment position with the City. Like most California public agencies, the City of Fort Bragg is facing the financial challenges associated with rising pension costs.

For several years the City has been exploring ways to reduce the City's Unfunded Accrued Liability (UAL) or pension liability. Here are some of the steps that the City has taken in the last 3 years.

- (i) During the FY 2019/20 Budget preparation, the City Council established a policy that fifty percent (50%) of any General Fund operating surplus realized at year-end would be used to pay down the City's UAL. As of the June 30, 2020, CalPERS actuarial valuation, the City's unfunded pension liability was \$11.5 million, an increase of 7.2% from 2019. The City's required annual contribution to CalPERS has also increased to \$1.4 million and is projected to be \$1.6 million in 2028. This is a conservative estimate with the likelihood that the increase will be significantly higher due to changes in CalPERS funding policies and poor investment returns.

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- (ii) In October 2021, the City Council approved a Pension Funding Policy to deploy various strategies to achieve the following objectives: reduce projected pension contributions to maintain services and increase the funding ratio for the City's Safety and Miscellaneous CalPERS plans.
- (iii) The City restructured its UAL Debt by issuing \$11.4 million in taxable Lease Revenue Bonds in November 2021, of which \$7.5 million were used to reduce the City's unfunded pension liability bringing the City's funding ratios up to over 95% from 66% for its pension plans. The restructuring would also yield savings of \$3.5 million over the next ten years and provide better fiscal stability with smoother annual payments for budgeting purposes. Additionally, CalPERS recognized a record 21.3% investment return for the fiscal year ended June 30, 2021, reducing the City's UAL further. Unfortunately, as of April 2022, CalPERS is at a -5% return on investment and is estimated to end the fiscal year with a negative rate return, which will result in a new significant UAL next year.

Looking ahead, to absorb future UAL when CALPERS has a bad investment year, there are a few options. One option would be to continue to fund pension costs on a "pay-as-you-go" basis, with the City making the minimum required contribution each year. As costs continue to increase, a more significant burden would be placed on the City's operating budget. A second option would be to make additional payments to CalPERS above the minimum required amount. The risk of this option is that the additional funds placed with CalPERS would be subject to the same investment volatility as other CalPERS funds. A third option, which many California municipalities have implemented, would be the establishment of a pension trust authorized under Section 115 of the Internal Revenue Code to accumulate funds to offset the unfunded liability and to smooth the impact of future cost increases.

The advantage of this option over depositing additional funds with CalPERS is that the City would retain control over managing the funds invested in the Trust. The funds would also be available to reduce the impact of future cost increases in those years when the City might be experiencing budget shortfalls.

Section: 115 Request For Proposal:

A Request for Proposals (RFP) for Section 115 Pension Trust Services was issued in April 2022. Two proposals were received from Public Agency Retirement Services (PARS) and CalPERS California Employers' Pension Prefunding Trust (CEPPT). The proposals were evaluated based on the firms' experience providing Section 115 pension trust services to other California municipalities and the managed funds' performance history and costs. Based on that analysis, PARS is being recommended as the preferred plan administrator.

PARS, which was established in 1984, has been designing and administering retirement plans and trust solutions exclusively for public agencies for the past 38 years. They currently administer over 2,000 programs for more than 1,000 public agencies, including 490+ Section 115 clients with 261 in California worth \$5.1 billion. PARS offers five

investment strategies and asset management fees for 25 basis points (0.25%) and 35 basis points (0.35%) for US Bank as trustee/custodian for the PARS program with HighMark Capital Management providing investment management services. Contributions to the trust fund are strictly voluntary by the City and can be accessed at any time. Fees are only charged when assets are added to the Trust.

In contrast, CEPPT administers and manages \$70 million in assets on behalf of 67 plans. Asset management fees are 25 basis points (0.25%) which is 35 basis points lower than PARS.

Funds are set aside in an exclusive benefit irrevocable Trust that cannot be accessed by creditors or used by the City for non-pension-related purposes. The Trust offers an opportunity for the City to invest in a more diversified array of investments to maximize investment returns long term and reduce the City's pension liability. PARS offers five investment program options based on risk tolerance levels. (Conservative, Moderately Conservative, Moderate, Balanced, Capital Appreciation)

Over the past ten years, the average rate of return for the five programs is 10.6% from 1-10 years, as depicted below. This rate of return is considerably higher than the rate which the City has realized on its investment portfolio and is another reason why many public agencies choose to participate in the PARS 115 Trust program.

NET PERFORMANCE FEE ANALYSIS

As of December 31, 2021

Over 1 Year		Over 3 Years		Over 5 Years		Over 10 Years	
PARS/HIGHMARK		PARS/HIGHMARK		PARS/HIGHMARK		PARS/HIGHMARK	
Capital Appreciation (25% Fixed Income/Cash)	14.96%	Capital Appreciation (25% Fixed Income/Cash)	17.30%	Capital Appreciation (25% Fixed Income/Cash)	12.15%	Capital Appreciation (25% Fixed Income/Cash)	10.83%
minus weighted PARS administration fee	(-) 0.25%	minus weighted PARS administration fee	(-) 0.25%	minus weighted PARS administration fee	(-) 0.25%	minus weighted PARS administration fee	(-) 0.25%
minus weighted HighMark investment management fee	(-) 0.35%	minus weighted HighMark investment management fee	(-) 0.35%	minus weighted HighMark investment management fee	(-) 0.35%	minus weighted HighMark investment management fee	(-) 0.35%
1-Year Net Return	14.36%	3-Year Net Return	16.70%	5-Year Net Return	11.55%	10-Year Net Return	10.23%
CALPERS CERBT		CALPERS CERBT		CALPERS CERBT		CALPERS CERBT	
Strategy 1 (30% Fixed Income/Cash)	13.72%	Strategy 1 (30% Fixed Income/Cash)	16.22%	Strategy 1 (30% Fixed Income/Cash)	11.26%	Strategy 1 (30% Fixed Income/Cash)	9.54%
minus fees	(-) 0.10%	minus fees	(-) 0.10%	minus fees	(-) 0.10%	minus fees	(-) 0.10%
1-Year Net Return	13.63%	3-Year Net Return	16.12%	5-Year Net Return	11.17%	10-Year Net Return	9.43%

* Subject to change due to rebalancing; fees are based on assets under \$5 million. Past performance does not guarantee future results.

While both vendors provide excellent pension trust options for the City and CEPPT fees are lower than PARS, Staff recommends that the City engages PARS to provide these services. The Primary drivers for this recommendation are an established track record and the size of the client base and assets under management with PARS.

Expected benefits offered by the PARS Trust Program to the City include:

- Over the past ten years, the average rate of return for the five investment programs has been 10.2%. This rate of return is considerably higher than the rate the City has realized on its investment portfolio and is another reason why many public agencies choose to participate in the PARS 115 Trust program
- Allows reimbursement to the City for up to 2 years of CALPERS employer contributions (current year + prior year) which can be helpful in an emergency or during a tough budget year
- Investment flexibility with Section 115 Trust compared to restrictions on general fund investments. PARS offers a choice of five active or five passive portfolios and customized options for asset balances over \$5 million.
- Oversight and control of fund management selection, monitoring of performance, and ability to replace fund management based on performance criteria
- Increased flexibility on the use of trust assets (i.e., trust assets can be accessed at any time as long as the assets are used to fund the City's pension obligations and defray reasonable expenses associated therewith)
- PARS does not charge minimum annual trading/transaction or disbursement fees. etc. All fees are asset-based.
- Potential for positive rating agency and investor consideration.

The program has been established as a multiple employer trust so that public agencies, regardless of size, can join the program to receive the necessary economies of scale to keep administrative fees low and avoid any setup costs. To adequately offset liabilities, funds must be set aside in an exclusive benefit, irrevocable Trust that creditors cannot access in order to be accounted for as assets to reduce the liabilities on the City's financial statements. The Trust permits the City, under federal and state law, to invest in a more diversified array of investments to maximize long-term investment returns and reduce the City's liabilities.

More than 430 public agencies have adopted Section 115 trust programs through PARS to reduce their liabilities, including local agencies such as the County of Humbolt, Lake County, City of Rohnert Park, and the City of Healdsburg, to name a few.

RECOMMENDED ACTION:

Approve and recommend to the City Council the establishment of an IRS Section 115 Pension Trust with Public Agency Retirement Services (PARS) for the purpose of Pre-Funding a Portion of the City's contributions to the California Public Employees' Retirement System (CalPERS) and Authorizing the City Manager to Execute all Documents to Fund and Maintain Participation in the Trust

ALTERNATIVE ACTION(S):

The Finance & Admin Committee could choose not to approve the establishment of a pension trust or direct Staff to investigate other trust providers in more detail. This is not recommended as Staff has performed an RFP process, and establishing a pension trust is a recognized best practice that will help the City achieve greater financial sustainability, as depicted in the City's Pension Policy.

FISCAL IMPACT:

The City currently has \$750,000 set aside in the unassigned Reserves (Surplus from FY 2020/21) and \$350,000 budgeted in the FY 2021/22 Adopted Budget. A total transfer of \$1.1 million would be made to the newly established Trust. Fees resulting from managing the Trust are embedded within the investment returns. There are no other costs associated with this action.

GREENHOUSE GAS EMISSIONS IMPACT:

There is no direct impact on greenhouse gas emissions.

CONSISTENCY:

The Pension Funding Policy incorporates the City Council policy of paying 50% of any year's General Fund surplus towards the City's UAL and furthers the City Council budget priority No. 6: Provide for additional contributions to CalPERS to pay the unfunded liability off earlier than 30 years.

ATTACHMENTS:

1. PARS Proposal
2. City's Pension Policy

NOTIFICATION:

N/A