AGENCY:	City Council
MEETING DATE:	June 27, 2022
DEPARTMENT:	Finance
PRESENTED BY:	Isaac Whippy
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AGENDA ITEM SUMMARY

TITLE:
Receive Finance and Administration Committee Recommendation 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 City Council is being asked to approve 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.

BACKGROUND
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. Over the last eight years, the City's aggregate UAL for its CalPERS Miscellaneous and Safety Plans has more than doubled, growing from $5.5 million to about $11.4 million (6/30/2020 valuation report).

In July 2021, it was announced that CalPERS earned 21.3% for FY 2021, and that the discount rate (their assumed earnings rate moving forward, as well as the amount charged to local agencies with respect to their UAL) was reduced to 6.80% in December 2021. The 21.3% gain will significantly reduce the City's UAL while the reduction in discount rate will slightly increase the UAL.

The UAL represents the shortfall/gap between what is actuarially expected to be needed to pay retiree benefits over time compared to the current assets on hand and expected earnings on those assets from City contributions, employee contributions and past CalPERS earnings. The $11.4 million of UAL debt is reduced over time through payments required by CalPERS. The payments are defined through multiple amortization schedules over 3 to 28 years, and interest is charged to the City at the current rate of 6.8%. Pension cost increases are the largest financial challenge facing most cities throughout the state and are primarily due to factors outside the City's control, including discount rate changes, assumption changes made by CalPERS and investment returns that were below expectations.

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.

(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.

(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 issued $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. Additionally, CalPERS recognized a record 21.3% investment return for the fiscal year ended June 30, 2021, reducing the City's UAL. Unfortunately, as of April 2022, CalPERS is at -5% return on investment, together with lowering the discount rate from 7% to 6.8% in December 2021 which will result in a new significant UAL.

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 larger 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. Cities and counties use section 115 Trusts to reserve funds against pension liabilities. Funds can be transferred from a Section 115 Trust to pay for pension costs; they cannot be used for other purposes.

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 serves 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 established in 2019 administers and manages $70 million in assets on behalf of 67 plans. Asset management fees are 25 basis points (0.25%). CEPPT offers only two investment strategies CEPPT#1 and CEPPT#2.

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 costs are lower than PARS, Staff recommends that the Committee engage 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.

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 Humboldt, Lake, City of Rohnert Park, and the City of Healdsburg, to name a few.

Public Agency Retirement Services (PARS)
As previously noted, PARS received their ruling from the IRS in 2015 becoming the first firm in California to offer the IRC Section 115 Trust for Pensions. Utilizing PARS to manage the City's Trust offers the following advantages:

- Over 20 years of experience administering Post-Employment Trusts for Public Agencies.
- Low equity requirements.
- Potential for greater investment performance. 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.
- Option to use the same 115 Trust for pre-funding OPEB and/or pensions obligations.
- More investment options, strategies and flexibility with Section 115 Trust compared to restrictions on general fund investments. PARS offers a choice of five active or five passive portfolios as well as 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)
- 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.
- 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 PARS IRC Section 115 Irrevocable Trust investments are held by the Trustee US Bank and managed by US Bank's investment arm HighMark Capital Management of San Francisco, CA. Should the Council choose to establish an IRC Section 115 Irrevocable Trust, the City will engage with HighMark Capital Management to set the investment objectives and strategy. PARS is one of three known vendors with a private letter ruling from the IRS that assures participants of the tax-exempt status of their investments. Should other more cost-effective alternatives become available, the Finance Committee will evaluate and make a future recommendation to explore transferring funds from PARS into another qualified IRC Section 115 Irrevocable Trust.

RECOMMENDED ACTION
Staff recommends approving the establishment of an IRS Section 115 Pension Trust with Public Agency Retirement Services (PARS) for 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 City Council 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:

Sufficient funds are currently available to make an initial contribution of $1,100,000 to the Section 115 Trust ($750,000 set aside in the Unassigned Reserves – 50% of Surplus from FY 2020/21 and $350,000 budgeted in the FY 2021/22 Adopted Budget.

The long-term impact of this near-term pension-related set of actions is impossible to quantify. It is fair to assume, however, that reserving funds for pension costs now and into the future will bring significant budgetary benefits over time. Over the past several years, CalPERS has lowered its discount rate by 50 basis points in recognition of the likelihood that the fund will not achieve projected investment returns. It is not unlikely that CalPERS will continue to reduce its discount rate. By fully funding its pension liabilities and using a more balanced rate of projected return, the City would set aside enough money to ensure that increasing pension-related costs will not crowd spending on other essential City projects and functions. This is both fiscally prudent and far-sighted.

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. City Resolution
2. City of Fort Bragg's Pension Funding Policy
3. PARS Proposal
4. PARS IRS Ruling Letter
5. PARS Administrative Service Agreement

NOTIFICATION:

Ryan Nicasio, PARS