Agenda Item Number: __9___

Agenda Report Reviewed by:
City Manager: ___

CITY OF SEBASTOPOL
CITY COUNCIL
AGENDA ITEM

Meeting Date:	November 16, 2021
To:	Honorable Mayor and City Councilmembers
From:	Ana Kwong – Administrative Services Director
Subject:	Review, Discuss and Approve the Work of Pension Liability Refinancing Process
Recommendation:	City Council Direction and Authorize Staff to Move Forward with the Work of Pension Liability Refinancing Process
Funding:	Currently Budgeted: ____ Yes _____ No ___XX__ N/A Net General Fund Cost: None

Account Code/Costs authorized in City Approved Budget _AK___ (verified by Administrative Services Department)

INTRODUCTION/PURPOSE:
This item is for City Council to Review, Discuss and Approve the Work of Pension Liability Refinancing Process.

BACKGROUND:
In May 2015, the City engaged Bartel and Associates, LLC in providing the City a comprehensive overview of pension obligations. The City participates in CalPERS providing retirement plan for its employees for Classic & PEPRA Miscellaneous, and Classic & PEPRA Safety Police and Fire. CalPERS "debt" is an estimate that is based on economic and demographic assumptions, including future investment returns, wage growth, mortality and many other factors. When actual experience deviates actuarial assumptions, the City's pension obligation can rise or fall rapidly. Pension obligations are particularly sensitive to investment returns since nearly two-thirds of the benefit funding is expected to be derived from investment earnings. Small changes in the expected investment return and actual experience can result in large fluctuations in the City's pension obligation. As we have seen in the last two decades, market volatility has had a profound impact on the affordability of pension plans. Rising pension costs have crowded-out many cities' ability to provide critical services to the public. Therefore, management of pension obligations require regular and appropriate attention to mitigate the impact on the City's financial health and ultimately, an ability to provide essential services. Since the City's accrued pension liability is built on a foundation of assumptions, this liability is an essence an estimate that can change rapidly as " real world" actual experience frequently differs from actuarial assumptions Back in 2015, Bartel made a few recommendations to mitigate future pension costs such as:

1. Issue Pension Obligation Bonds (POB)
2. Borrow from General Fund Reserve
3. One time payments – City Council resolution for use a portion of one time money to address the issue.
4. Establish an Irrevocable Supplemental §115 Pension Trust

At that time, the City was not in a position to exercise any of the above recommendations.

Fast forward to today, the financial markets and the City's circumstances are very different. In order to better control future required contributions from the general fund, the City should exercise some of the recommendations as a necessary means to "smooth" out the general fund contribution requirements to CalPERS and position ourselves in the place where unfunded liability is manageable from year to year.

DISCUSSION:
In brief, the City's annual required contribution to CalPERS consists of two components, the normal cost and a scheduled payment toward the unfunded accrued liability(UAL) . The annual require contribution is the total amount that CalPERS

actuaries has determined should be contributed by the City and its employees to complement expected investment earnings such that all benefits are paid and all administrative costs are covered. CalPERS invests the amounts collected on behalf of local agencies to offset the cost of providing future benefits to retirees. The investment earnings or losses s are allocated to each participating member agency annually adding to or detracting from the City's Market Value of Assets (MVA).

CalPERS actuaries also determine the Actuarial Accrued Liability (AAL) for all member agencies. The AAL is the actuary's projection of the total amount that CalPERS should currently have to cover promised benefits over time (accounting for investment earnings and future annual billings to the member agencies). If the AAL exceeds the MVA, the member agency's "account" is in a deficit position and a UAL exists.

A key element for the actuarial calculations is the discount rate, which is the rate of return that CalPERS assumes it will realize on its investments. CalPERS has been slowly lowering its discount rate in recognition that its assumptions about rate of return have been overly optimistic. In the early nineties, the investment earnings assumption was as high as 8.75% and has steadily drifted downward to 7.0% and will likely be reduced again in November of this year impacting contribution rates in fiscal year 2023-24.

Another way to think of the UAL is as a debt that has a principal amount and an interest rate; CalPERS effectively thinks of the UAL as a means to recover shortfalls between assumptions and experience. Every assumption change or experience gain or loss creates an additional obligation layer that collectively comprise the UAL. This series of layers (or bases) are structured like individual loans each with their own repayment schedule. In other words, the City's UAL is a debt-like obligation. It is amortized by CalPERS at an assumed rate of return (currently 7.00% but being reviewed and likely to drop to 6.8% or 6.5%). This UAL is amortized over a period of time currently 20 years, formerly as long as 30 years. When CalPERS does not meet its earnings rate, it adds to the City's UAL. If CalPERS exceeds its earnings rate, it can reduce the City's UAL. In this light, the UAL is a debt that can be refinanced through the issuance of fixed-rate, callable pension obligation bonds that carry a lower interest rate than the discount rate. The debt transfers from CalPERS to the bond issuers**.**

Worth noting that for FYE 2021, CalPERS did earn 21.3% and therefore a credit base will be created the UAL payments over time assuming all future actuarial assumptions are met. If an investment loss is incurred in future years, this will create a new loss base that will offset some or all of the one-year favorable investment return.
Due to sluggish investment growth, assumption changes and mortality rates decreases, the City CalPERS costs have trended higher.

- The City's UAL has increased by about $5 million since 2015 (from approximately $9.5 million to about $14.6 million).
- The City's funded status has dropped by about 5.5%, and is currently at 72% funded in the miscellaneous plan and 66% funded in the safety plan.
- The City's UAL payments to CalPERS have been increasing and are projected to continue to increase. In 2016, the City's UAL payment to CalPERS was about $580,000. In 2021, it was about $1.3 million.

It is important to recognize that the City does have options to manage its retirement obligations. There are strategies to mitigate the rising pension costs including:

- Making UAL upfront payments to CalPERS (City staff is already doing this)
- Making Additional Discretionary Payments (ADPs) to CalPERS
- Establishing a Section 115 Trust
- Issuing POBs

It is no secret that Interest rates are near historical lows. The 30-year Treasury is at about 2.0%. This current market has spawned the issuance of POBs. Over 70 agencies have issued POBs since 2019. In 2020, the volume of POB issuance was about $4.5 billion and so far in 2021, the volume is over $7 billion. Interest rates on POBs are in the 3.0%-4.0% ranges versus the 7.0% charged by CalPERS. Interest savings provided by a POB can be coordinated with funding a Section 115 Trust to establish pension stabilization for future pension costs.

Under California law the UAL is consider debt that can be refinanced by the issuance of POBs and do not require voter approval. They do, however, require a court validation to reaffirm the obligation imposed by law. This process is led by Bond Counsel and takes about 60-90 days.

Whether the City makes ADPs or issues POBs, there is no way to eliminate future UALs that CalPERS will assign due to underperformance of their investments. Payoff solutions allow the City to pay down liability at the present value presently owed and therefore save on interest cost. CalPERS' future performance will determine how and when a future UAL will be assigned and amortized.

Staff is asking for the City Council for approval to engage a financing team to work on solutions to mitigate pension costs. If approved, the financing team will bring documentation back to Council in December to begin the process of validation in order to keep a POB option available. The financing team will analyze UAL payoff solutions, incorporating forthcoming CalPERS assumption changes. Staff will report back to Council in the first quarter of 2022 for payoff solution and approval.

GOALS:

This action supports the following City Council Goals and General Plan Actions:

- Operate City government in a fiscally responsible and responsive manner.
- Develop and Implement Sound Financial Management Policies and Procedures
- Review the City Council Financial Polices to ensure they meet the needs of the City
- Create easy to read documents that educate the public and community on City Finances.
- Encourage and increase public awareness of City Policies, decisions, programs and all public processes and meetings

PUBLIC COMMENT:

As of the writing of this staff report, the City has not received public comment. If staff receives additional public comment from interested parties following the publication and distribution of this staff report, such comments will be provided to the City Council as supplemental materials before or at the meeting. In addition, public comments may be offered during the public comment portion of this item.

PUBLIC NOTICE:

This item was noticed in accordance with the Ralph M. Brown Act and was available for public viewing and review at least 72 hours prior to schedule meeting date.

FISCAL IMPACT

There is no fiscal impact associated with discussion as staff will return to the City Council at future meeting date to discuss funding strategies.

RECOMMENDATION:

City staff recommends that the City Council Direction and Approve Staff to Move Forward with the Work of Pension Liability Refinancing Process.

ATTACHMENTS:

Pension Primer
PowerPoint Presentation

Defined Benefit Pension Plan Primer

Quick Notes

Defined Benefit (DB) vs. Defined Contribution (DC) Plans:

DB plans are employer-sponsored retirement plans where the benefit to be paid to the retiree is known. (e.g. pension) Whereas, DC plans are retirement plans where the contribution paid during employment is pre-defined (e.g. 401k and 457b) and there is no further obligation beyond the initial contribution.

Pension Liabilities Terms:

Accrued liability (AL) represents the total dollars needed as of the valuation date to fund all benefits earned in the past for current members and former plan members. This represents the present value of future benefits earned for service *already* earned/rendered.

Funded Status is the ratio of MVA to AL (MVA ÷ AL)

Market Value of Assets (MVA) represents the fair value of assets set aside, in trust, to fund the AL as of a given measurement date.

Present Value of Projected Benefits (PVPB) represents the total dollars needed as of the valuation date to fund all benefits earned in the past and expected to be earned in the future for current and former plan participants. In other words, it is the target balance of plan assets necessary to fund the promised benefit to plan participants at their projected retirement date.

Unfunded Accrued Liability (UAL) represents the arithmetic difference between the AL and the MVA. It is a measure of the funding shortfall relative to the AL.

The City of Sebastopol participates in the CalPERS agent multiple-employer, defined-benefit (DB) pension plan under §401(a) of the internal revenue code (IRC). This code section also provides for defined contribution (DC) plans where the employer's sole responsibility is to make a defined contribution (DC), if any, and all other risks are borne by the employee. However, in a DB plan, the employer guarantees some pre-defined benefit level at retirement and the City bears all risks associated with the promise.

In many states, including California, it is extremely difficult to unwind a defined benefit plan. California Supreme Court decisions dating back 70 years, collectively known as the California rule, guarantee that public workers are entitled to the retirement benefits in effect when they start their employment. Courts have ruled that a public employer who changes the terms of a pension must in turn provide a benefit of equal value. While plans can be closed to new participants, plan sponsors can face an enormous plan termination liability which assumes that no further employer contributions will be made and that all future investment earnings are invested at a risk-free investment rate of return.

Characteristics of DB Plans

All DB pensions plans include a collection of demographic and economic assumptions that drive both the target benefit and cost of the plan over time. These assumptions include expected investment earnings, payroll growth, life expectancy and others. The collection of assumptions forms the foundation for the "normal cost" of the plan, that is if actual results meet all of the actuarial and economic assumptions, the normal cost will fully fund the target benefit.

Discount Rate

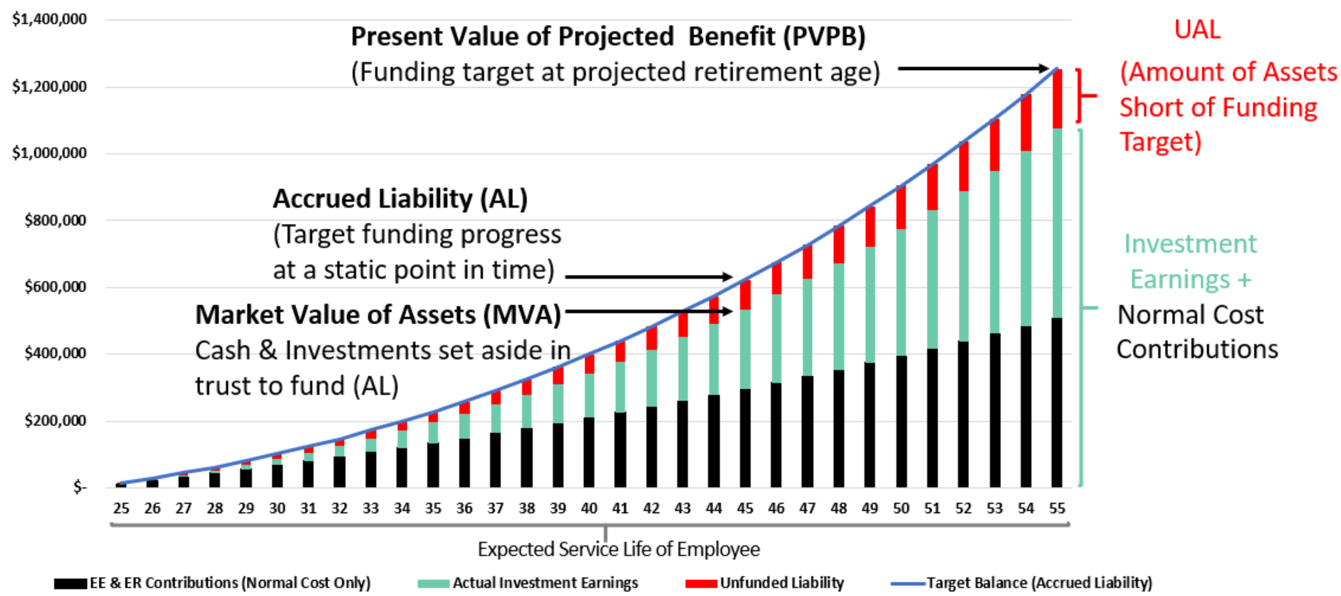
The discount rate is an important actuarial assumption that drives the cost of the plan. It represents the long-term *expected* rate of investment return that can be expected from the plan's investment strategy and portfolio. Since the promised benefit formula is fixed and guaranteed by the employer, a decrease in the assumed investment return (discount rate) directly impacts the employer's cost of the promised benefit. Since nearly 2/3 of a plan's funding is derived from accumulated investment earnings, any change to the discount rate can have a profound impact on the employer's cost of funding the benefit. With respect to the CalPERS plan, the discount rate has been as high as 8.75% through 1993 but has since dropped to 7.0% and further reductions in the discount rate may be in the not-too-distant future.

Key Impacts to Accrued Liabilities

Experience Gains/Losses
When actual results differ from the assumptions, these deviations are called "experience gains and losses." Each year, experience gains and losses are measured and added to or subtracted from the unfunded accrued liability (UAL) in the form of a new gain/loss *layer* or "base" and are phased-in (amortized) into the City's annual required contributions over a period not to exceed 20 years (previously 30 years). The collective layers of gain/loss (positive or negative) bases form the UAL which may have a remaining term between 1 and 29 years.

Changes in Actuarial Assumptions
When long-term plan assumptions are adjusted up or down, these changes are called "changes in actuarial assumptions." Changes in assumptions create their own, new gain/loss bases which are also amortized into the plan cost over a period not to exceed 20 years. Different than experience gains/losses, changes in long-term assumptions also impact the ongoing normal cost of the plan.

Illustration of Key Actuarial Terms



Historical Factors Impacting CalPERS Funded Status

The events that contributed to large unfunded pension liabilities for public employers and a lower funded status for the pension system as a whole can be summarized in the following illustration:

Source: CalPERS

In the late 80's and 90's, CalPERS' investment returns were very strong, resulting in most plans accumulating more assets than their plan liabilities. By 1999, the CalPERS system reached its peak funded status where plan assets climbed to 128% of plan liabilities. Since investment earnings offset employer plan costs, the plan benefits appeared to be relatively inexpensive. Senate bill (SB) 400 and assembly bill (AB) 616 provided employers the ability to significantly enhance pension benefit levels to both safety and miscellaneous plans. Many local agencies began implementing the enhanced benefit levels, seemingly for free since plan assets exceeded plan liabilities. Any remaining agencies that had not increased benefits quickly felt pressure from bargaining units that argued their agency needed to follow suit, in order to remain competitive in attracting and retaining employees or lose out to surrounding communities. Agency after agency increased pension benefit levels to keep pace with their neighboring communities.

Subsequent market corrections and recessions revealed that the benefit enhancements were in fact not free and were prohibitively expensive. At its peak, the expected average annual return or discount rate was 8.75% and was supported by historical earnings patterns. Since then, market returns have not supported the previous investment income assumptions. Therefore, pension plan administrators, including CalPERS, have been forced to adjust the discount rate assumption downward which in turn increases the cost of the promised employee benefit to employers. The current CalPERS discount rate now stands at 7%. Even still, as fixed income yields have contracted to near zero levels, investment portfolio managers are faced with the dilemma of taking on more investment risk or lowering discount rates even further.

Over the last two decades both experience losses and changes in assumptions have significantly impacted the funded status of the CalPERS pension plans, driving the employer costs to worrisome levels contributing to pension reform and the current pension crisis. In 2012, the California legislature passed the Public Employees' Pension Reform Act (PEPRA), championed by former Gov. Jerry Brown. PEPRA took effect January 1, 2013 and places limits on the level of pension benefits. While this reform is significant, due to a provision in the California constitution often referred to as the "California Rule," the PEPRA limitation only applies to employees hired after January 1, 2013 AND are either new to the pension system or had a break in service in excess of 6 months. Therefore, the impact of PEPRA will not provide employers significant relief for decades to come.

BRANDIS TALLMAN
A DIVISION OF OPPENHEIMER & CO. INC.

SEBASTOPOL
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CITY OF SEBASTOPOL
DISCUSSION OF CALPERS PENSION COSTS AND PENSION MANAGEMENT OPTIONS

November 16, 2021

MSRB G-17 NOTICE

Underwriter G-17 Notice

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CalPERS Costs Trending Higher - How did we get here?

Then:

- PERS investment returns were robust (10%+) and "Super-Funded" through the 1990s
- In 2000 SB 400/ AB 616 increased benefits retroactively
- Dot-com crash in early 2000s dropped investment returns to -6% and -7%
- Loss of Super-Funded status
- Great Recession caused significant investment losses (approx. 30%)

Recently:

- Sluggish investment growth (<6%)
- Assumptions are changing
  - Expected returns:

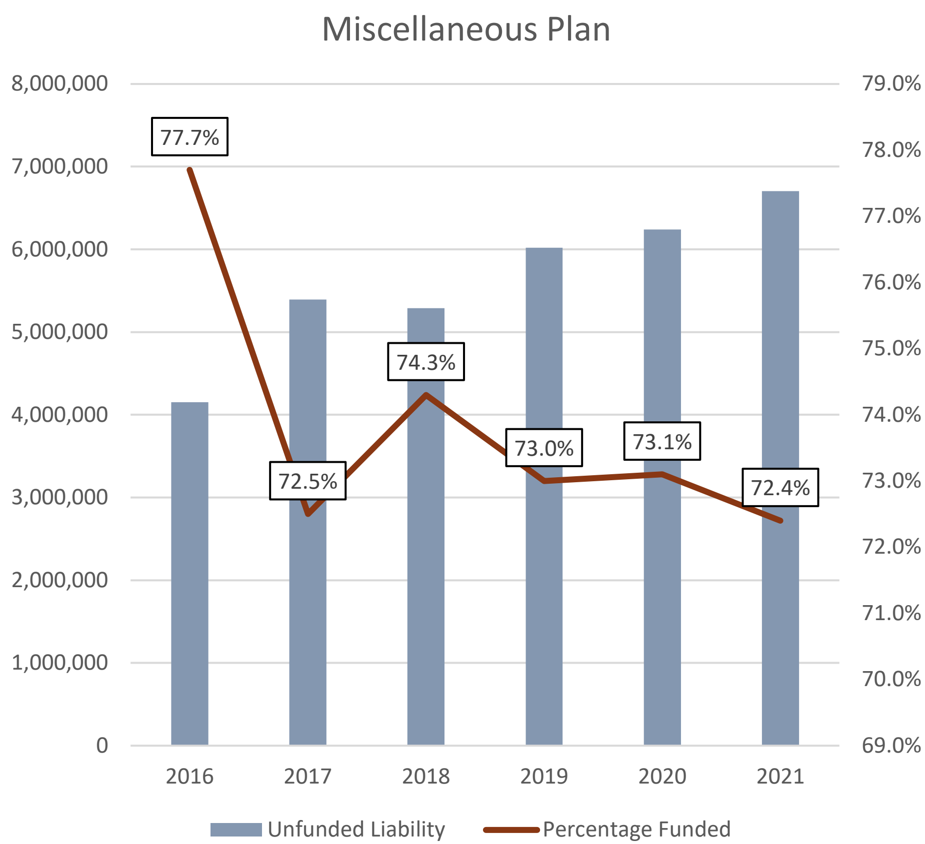
    8.25% → 7.75% in 2003; 7.75% → 7.50% in 2013; 7.00% in 2020; Changing to 6.80% or lower in 2021
  - CalPERS estimates that the probability of achieving 7.0% returns over 10 years is 39%
  - Mortality rates (people living longer)

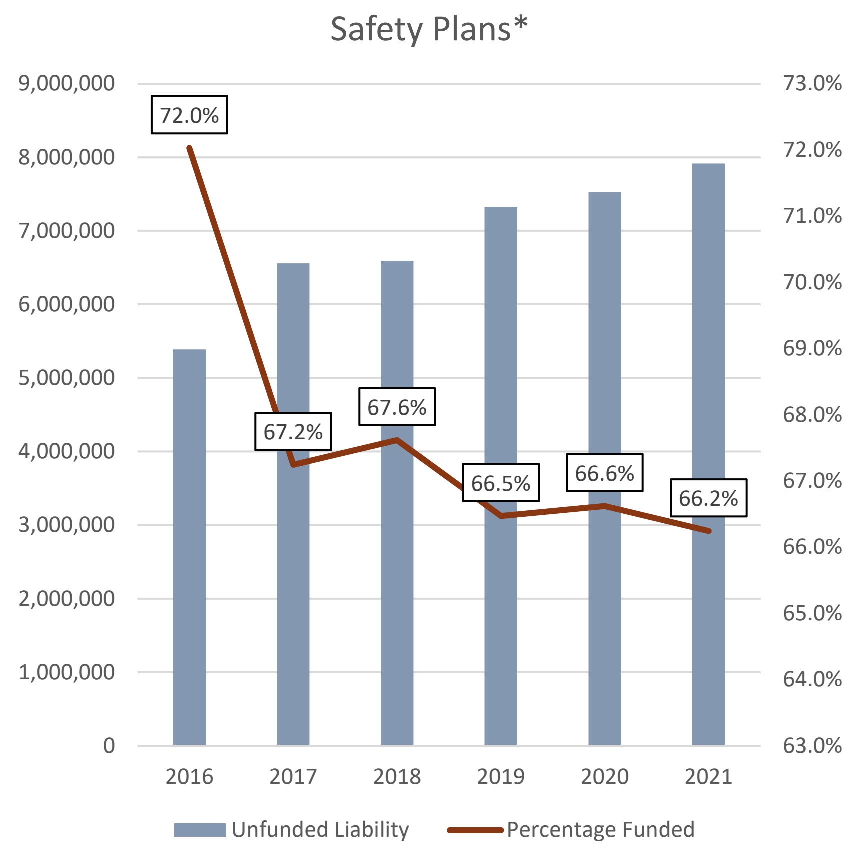
Note: CalPERS manages investment; agencies bear all investment risk.

Why Discuss Pension Management Options?

- City of Sebastopol currently has a $14.6 million Unfunded Accrued Liability (UAL) with CalPERS (classic plans only)
- CalPERS costs have trended higher
- City's UAL has increased over the last several years
- There are strategies to mitigate rising pension costs
- Current low interest rate environment creates opportunity to refinance CalPERS obligation

City's UAL and Funding History

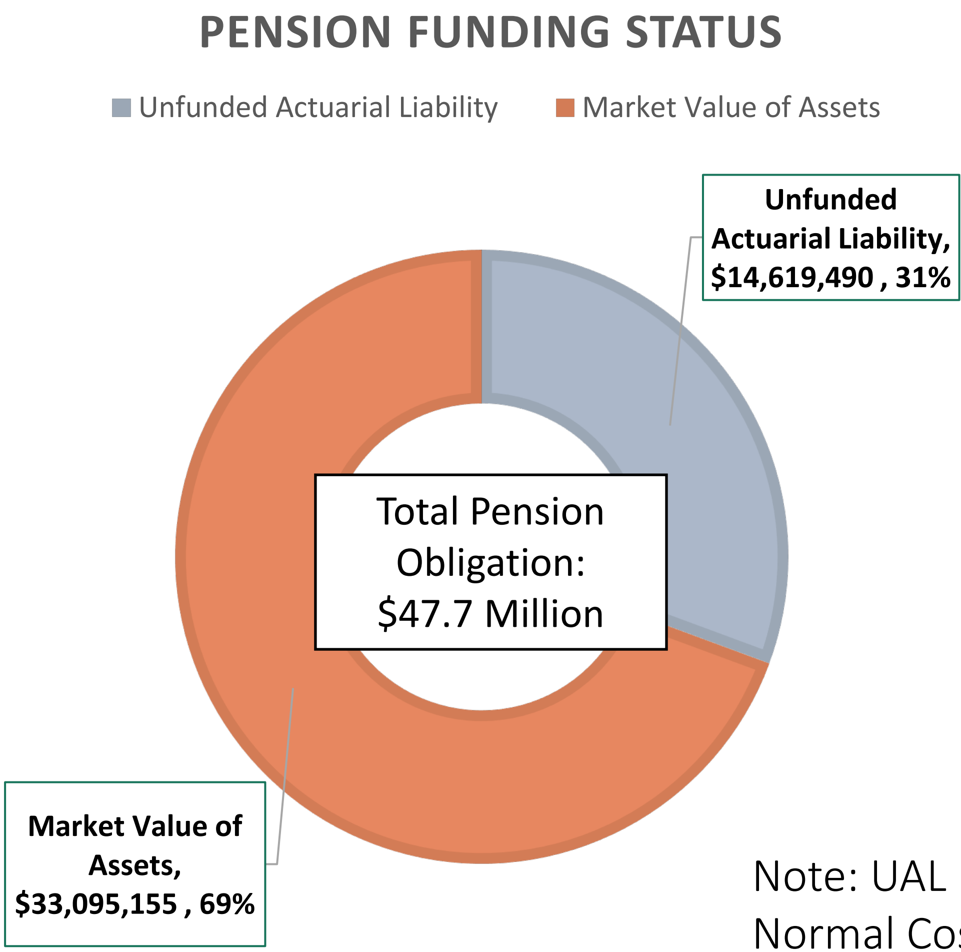




*For this discussion, the City's Safety Police and Safety Fire have been combined. The Safety Police Plan is much larger, accounting for 91% of the combined Safety Plans unfunded liability.

Source: CalPERS Annual Actuarial Valuation (June 30, 2020)

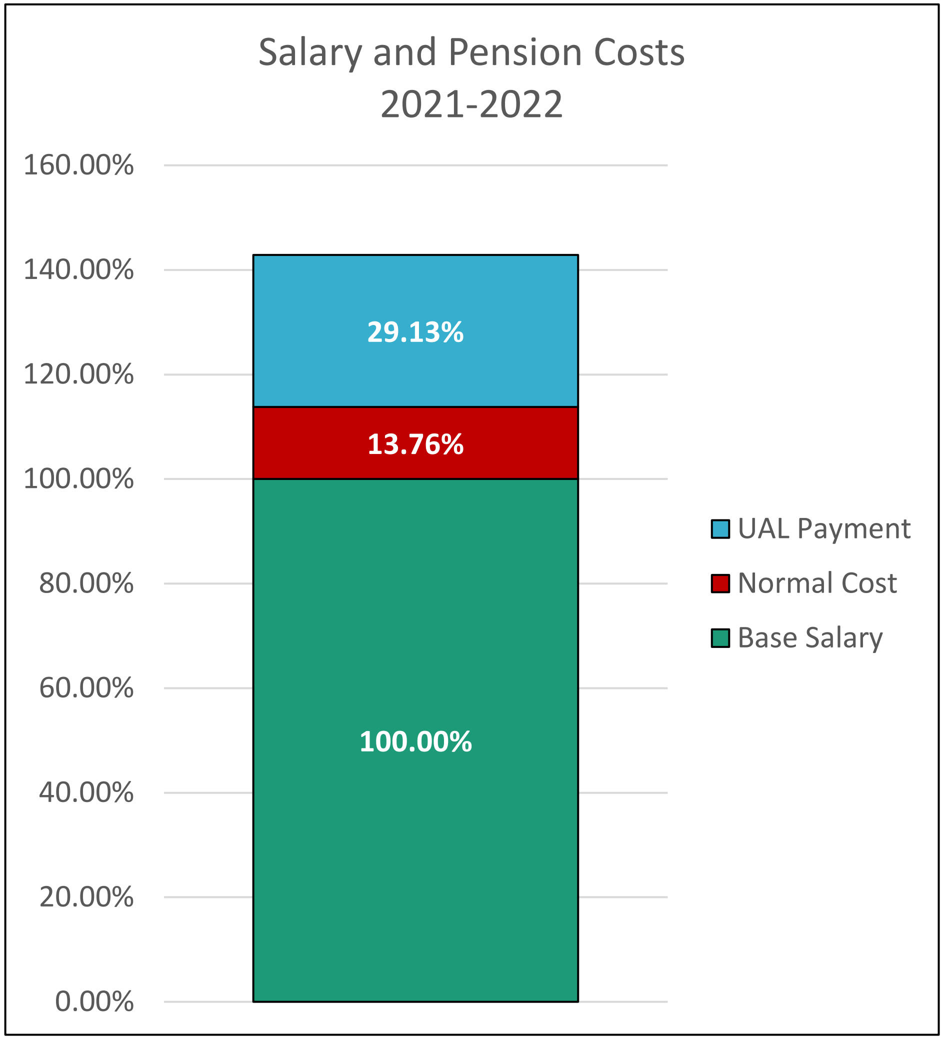
City's Current Pension Funding Status



- Total Pension Obligations = $47.7 Million
- Pension Assets = $33.1 Million
- Shortfall (UAL) = $14.6 Million
  - Debt Owed to CalPERS
  - Amortizes over time (20-30 years)
  - Accrues Interest at 7% interest rate
  - No prepayment restrictions

Note: UAL Repayment is in addition to the City's Normal Cost paid each pay period

Pension Costs Overview – All Pension Plans



Two types of payments to CalPERS:

Normal Cost:

- Annual pension benefit cost for current employees
- % of payroll

UAL Payment:

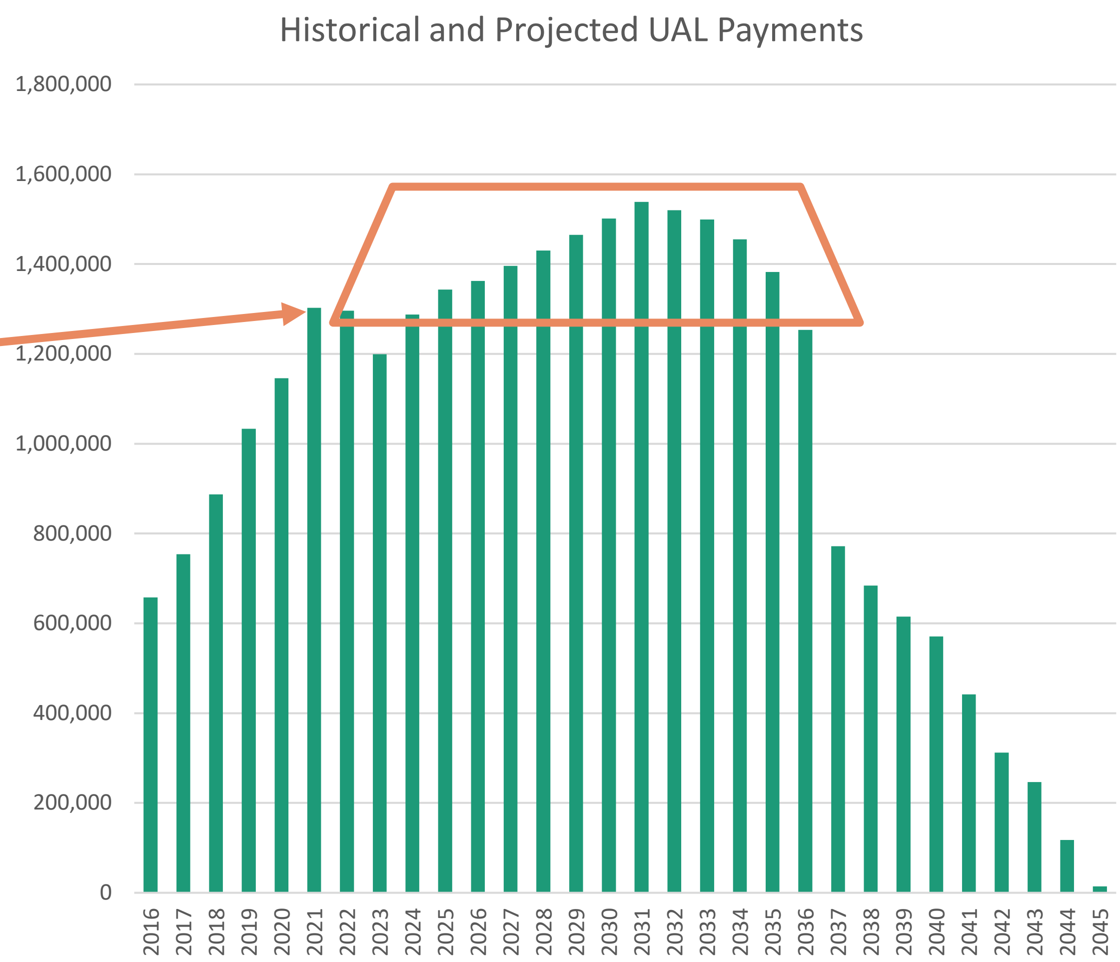
- Repayment of pension funding shortfall
- Fixed dollar amount
- Includes interest at **7%**

Note: Chart does not include employee contributions.

Source: CalPERS Annual Actuarial Valuation (June 30, 2020)

Repayment of the UAL to CalPERS

- The rapid increase of the City's UAL has created an uneven UAL debt repayment shape
- City's UAL payment in 2021 was approximately $1.3 million. Payments due to CalPERS will surpass this amount for much of the next 16 years
- Note: 2021 CalPERS returns are strong (21%) and are likely to reduce the City's UAL
    - However CalPERS is likely to reduce the discount rate again to absorb some of these strong gains



Source: CalPERS Annual Actuarial Valuation (June 30, 2020)

What are Strategies to Mitigate Rising Pension Costs?

- Pay Annual UAL Payment Upfront in Fiscal Year ✓
- Use Available Cash to Periodically Pay Down UAL
- Fresh Start Amortization
- Participate in Section 115 Trust Program
- Issue Pension Obligation Bonds (POBs)
- Adopt Pension Funding Polices to Codify Strategies

Market Rates – 30 Year Treasury History

***30-year treasury rates are near their historical all-time lows (March 9, 2020)**

Source: US Department of the Treasury

Restructuring UAL with a Pension Obligation Bond

- City 'borrows' money to pay all or a portion of the UAL to CalPERS

  Pension liability payments can be reshaped. POB can provide level debt service payments to create better budget predictability and fiscal sustainability. POBs can have a shorter term than the existing UAL.

  - POBs are validated obligations imposed by law and therefore do not require voter approval. The validation process typically takes 60-90 days.

  - City can achieve savings with POBs. All-in POB interest cost estimated at 3.45%; much lower than 7.00% (soon to be 6.80% or less) charged by CalPERS.

- Initial analysis shows that a POB Issuance with a 15-year term results in level annual payments of $880,000. This would create approximately **$154,000 of average fiscal year savings** through 2036, and **total savings of $3,245,000.**

  - Savings can be deposited into a 115 Trust Account

UAL After a POB Issuance

- If the current UAL is paid in full, future CalPERS investment performance will determine whether additional UAL is created. Should CalPERS fail to achieve the projected rate of return, the shortfall will cause the creation of a new UAL.

- Conversely, should CalPERS achieve higher-than-expected returns, the excess would be credited to the employer’s fund and thus available to offset any future increases in the UAL caused by a subsequent underperformance in a given year.

- There is no possible way to eliminate the potential for future UAL to accrue due to underperformance of CalPERS without exiting the CalPERS system entirely.

- Payoff solutions allow entities to pay down liabilities presently owed, with the ability to save money in the future by reducing interest expense. Eliminating today’s UAL is in no way a means of eliminating the risk of future underperformance by CalPERS.

Recommendations

- Direct City Staff to proceed with pension liability refinancing process
- Direct City Staff to assemble financing team
  - Municipal Advisor
  - Pension Consultant
  - Bond Counsel
  - Underwriter

The financing team will prepare multiple scenarios and analysis to provide options for the City to mitigate its rising pension costs.

If City Council Approves for Staff to Move Forward with Pension Refinancing Process…

- Financing Team will bring Trust Indenture to Council for approval in December, which would kick off the validation process. Validation filed and completed by Bond Counsel, and confirms the POBs are an obligation imposed by law

- Dec. 2021 - March 2022, analyze and determine size and structure of UAL payoff, and prepare Preliminary Official Statement (POS) and other necessary documents

- Financing Team returns to Council in March of 2022 for approval of the POS and other documents associated with the financing

- The POBs would be priced in late March/early April, and the Financing would close in April

- In order for the UAL payoff to be reflected in the June 30, 2021 Actuarial Valuation Report (provided in July of 2022), the payoff would need to occur by the end of April, 2022

Questions?

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