STAFF REPORT

AGENDA NO:

MEETING DATE: July 3, 2017

To: Honorable Mayor and City Council

Date: July 3, 2017

From: Carol Augustine – (650) 558-7222

Subject: Review of Options Available for Pre-funding Pension Obligations

RECOMMENDATION

Staff recommends that the City Council review and discuss options and future strategies for pre-funding the City's pension obligations.

BACKGROUND

The City of Burlingame has two pension trusts within the California Public Employees' Retirement System (CalPERS): one to fund public safety employees, and one for miscellaneous employees. Pension benefits are funded by employer and employee contributions and by investment earnings on those contributions. Numerous assumptions, including actuarial assumptions about employee and retiree populations and assumptions about investment returns, are used to determine the funding required for payment of pension benefits. The most critical assumption in attaining full funding goals is the rate of return on investments in the trusts. CalPERS' current annual rate of return (ROR) assumption is 7.5 percent. Assuming this rate of return is attained, then funding of the pension obligations would be derived 66 percent from investment gains and 34 percent from contributions. If the 7.5 percent rate of return is not realized, then contributions from employers will have to increase, as employee contribution increases are currently limited by Public Employee Retirement Law.

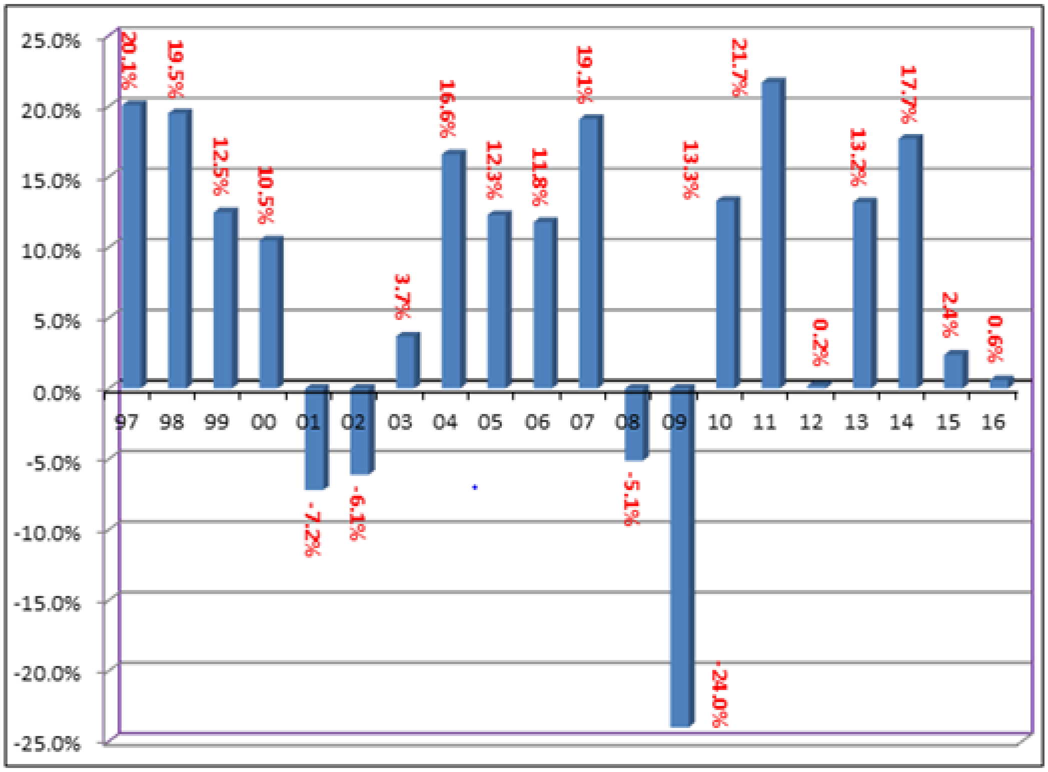
Unfortunately, this ROR has not been achieved by CalPERS in the past two years (2.4 percent in FY 2015 and 0.6 percent in FY 2016), and the outlook from the investment community and actuaries for a 7.5 percent annual rate of return is increasingly pessimistic. In fact, the average actual rates of CalPERS returns in the table below have fallen below expectations in several time periods.

Time Period	Rate of Return
Three years	6.86 percent
Five Years	6.77 percent
Ten Years	5.08 percent
Twenty Year	7.03 percent

Return volatility is also a concern as CalPERS looks to move to a more "risk averse" portfolio in the future.

CalPERS History of Investment Returns

The following is a chart with the 20-year historical annual returns of the Public Employees Retirement Fund for each fiscal year ending on June 30. Beginning in 2002, the figures are reported as gross of fees.



As a consequence of the above performance, a prolonged low-interest rate environment, and attempts to limit future volatility in investment returns, the CalPERS board approved a plan to reduce the assumed ROR from 7.5 percent to 7.0 percent over a three-year period. The December 2016 decision was, in part, based on outside investment advisors' belief that investment returns over the next 10 years will be well below the 7.5 percent current assumed return, and likely even below 7 percent. The ROR will decrease as follows:

Valuation Date	Discount Rate	Fiscal Year of	
		Initial Impact	Full Impact
6/30/2016	7.375%	2018/19	2022/23
6/30/2017	7.250%	2019/20	2023/24
6/30/2018	7.000%	2020/21	2024/25

This decrease in the ROR assumption means that investment returns will be relied upon less, and contributions relied upon more, in order to fund pension obligations. The resulting higher contribution rates for employers and employees will exacerbate existing pension funding challenges. As the ROR decreases, these funding levels will drop, placing the City further behind in meeting pension obligations.

Over the past several years, the City has taken several steps to manage pension costs. For example, the City has negotiated pension cost-sharing agreements with each bargaining group. Under a cost-sharing arrangement, employees agree to pay a portion of the *employer's* required pension contributions, in addition to the standard employee contribution required by CalPERS. Currently, these additional contributions equate to 1.5 percent of base salary for miscellaneous employees and (currently) 3.0 percent for safety employees (increases to 4.0 percent January 1, 2018). Note that, although these cost-sharing agreements assist the City in paying the required annual payments to CalPERS, such arrangements do not provide any additional payment toward the City's unfunded liabilities.

In 2013, the Public Employee Pension Reform Act (PEPRA) was enacted at the state level; this law required contracting agencies to implement a lower pension benefit formula for new hires that are new CalPERS members. PEPRA also included new restrictions of pensionable compensation, designed to limit the accrual of unfunded liabilities over time. As the newer PEPRA formulas only apply to recent hires, there has been little immediate impact on the City's total pension costs. However, such changes will reduce future liabilities and costs over the long-term.

For FY 2016-17, the City paid $5.3 million for both pension plans: $3.4 million, or 22.9 percent of payroll, for the Miscellaneous Plan; and $1.9 million, or 40.6 percent of payroll, for the Safety Plan. The General Fund's share of the total is approximately $4.0 million, or 75.5 percent. Other City funds, such as the Sewer and Water Funds, contribute the remaining 24.5 percent.

As of June 30, 2015 (the latest actuarial valuation from CalPERS), the City's Unfunded Actuarial Accrued Liability (UAAL) for the Miscellaneous Plan was $29.0 million, and $20.3 million for the Safety Plan, totaling $49.3 million. As the table below shows, the total unfunded liability is projected to grow to $51.9 million as of June 30, 2017.

City of Burlingame
Unfunded Actuarial Accrued Liability (millions)

	Miscellaneous		**Safety**	
	6/30/15	Projected 6/30/17	6/30/15	Projected 6/30/17
Actuarial Accrued Liability	$128.1	$126.7	$ 83.5	$ 82.2
Market Value of Assets	$ 99.1	$ 96.5	$ 63.2	$ 60.5
Unfunded AAL	**$ 29.0**	**$ 30.2**	**$ 20.3**	**$ 21.7**
Funded Ratio	77%	76%	76%	74%

**Based on 6/30/15 actuarial valuation from CalPERS (discount rate = 7.5%)*

Based on the actuarial valuation performed for the City to *include* the impact of the discount rate assumption, as of June 30, 2017 the miscellaneous group is estimated to be 70.1 percent funded, while funding of the public safety group liabilities stands at 69.0 percent.

The unfunded liabilities associated with CalPERS plans reflect two primary factors: pension commitments made to now-retired employees under inaccurate assumptions, and decisions by

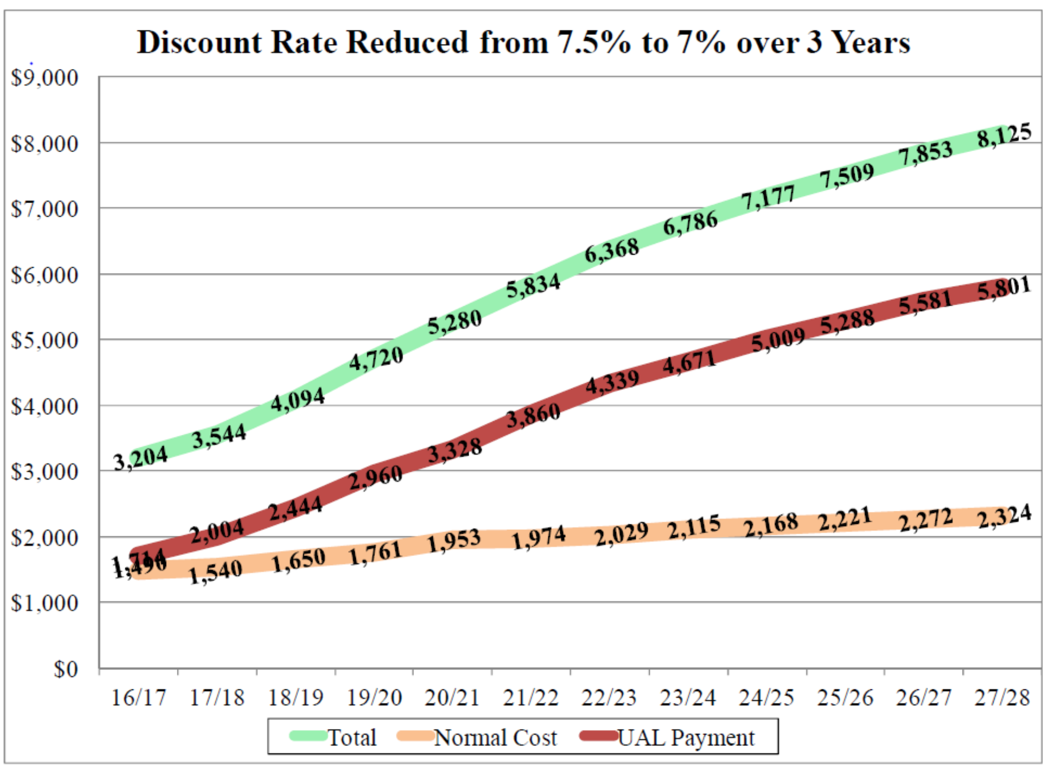
CalPERS to amortize investment losses over a long period of time. Assumptions that turned out to be inaccurate include lower-than-anticipated investment returns, longer-than-anticipated lifespans, and underestimating the cost of benefit enhancements negotiated in the past. Past investment losses were amortized over a 30-year period, which had the positive benefit of limiting annual contribution increases, but which did not adequately pay down unfunded liabilities. As a result, the City now needs to substantially increase annual payments to CalPERS to fully fund benefits.

The City's unfunded liability primarily is related to retired or inactive employees: nearly 70 percent of the unfunded liability for the Miscellaneous Plan is associated with retired or inactive employees, and 74 percent of the unfunded liability for the Safety Plan is associated with retired or inactive employees. The General Fund's share of the total unfunded liability is approximately 75.5 percent.

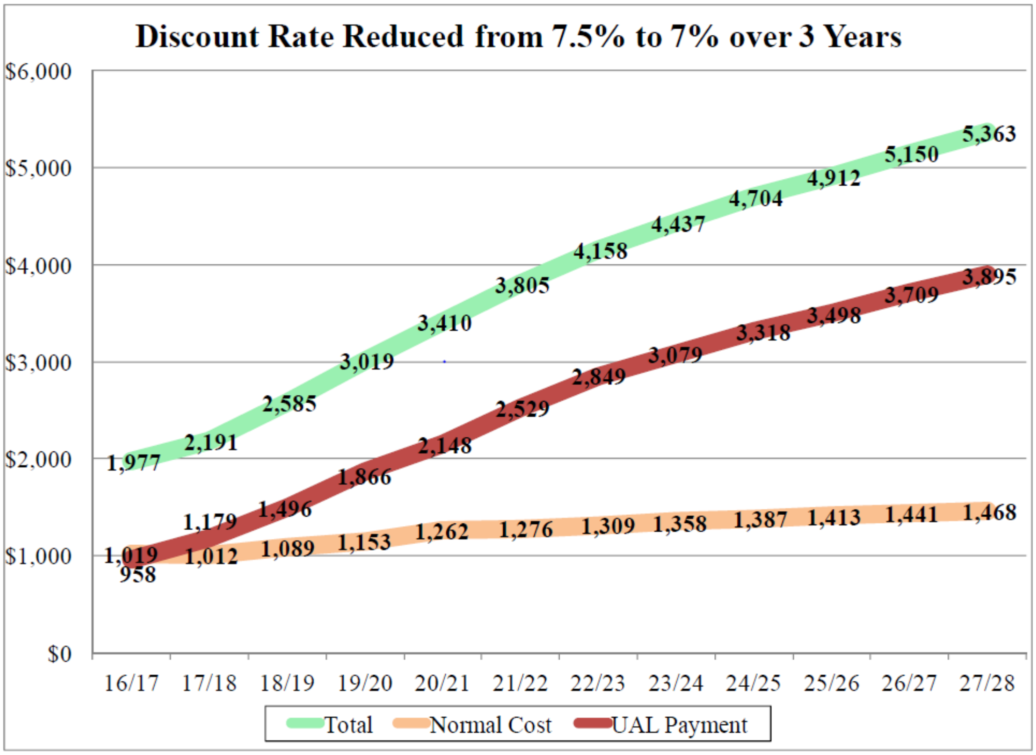
DISCUSSION

In order to assess the City's long-term pension obligations, the City engaged Bartel Associates, LLC, to model the actuarial valuations of the City's pension plans over the next 30 years. Bartel's projections illustrate that the City's annual required contributions will increase significantly in the next 10 years. Note that the employer's total rate includes a payment for the Unfunded Actuarial Liability (UAL), which is the present value of benefits earned to date that are not covered by current plan assets, as well as the Normal Cost, which represents the cost of projected benefits that is attributable to active employees for the current fiscal year. (The employer normal cost equals the total normal cost of the plan reduced by employee contributions.)

CONTRIBUTION PROJECTIONS - MISCELLANEOUS

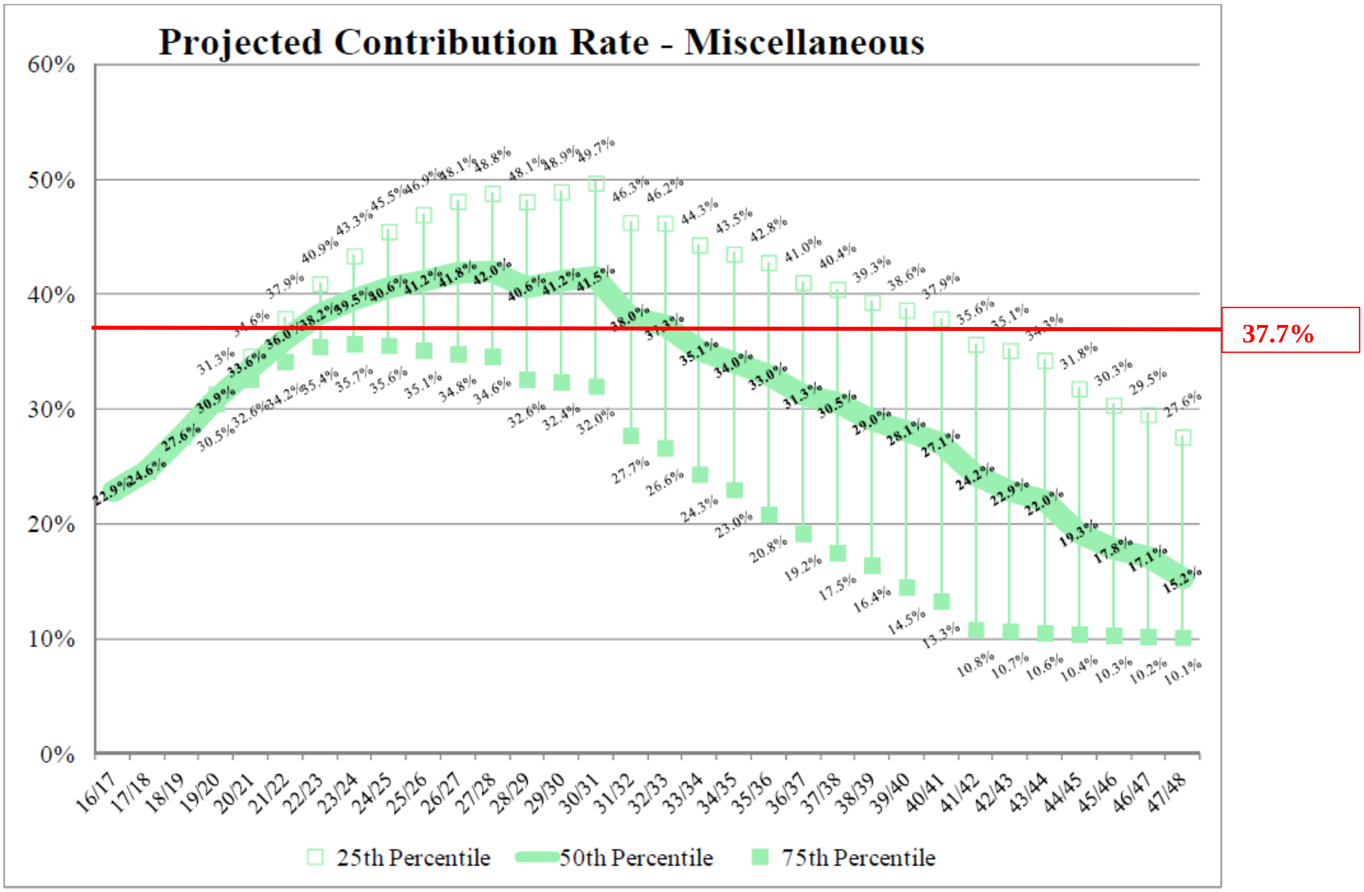


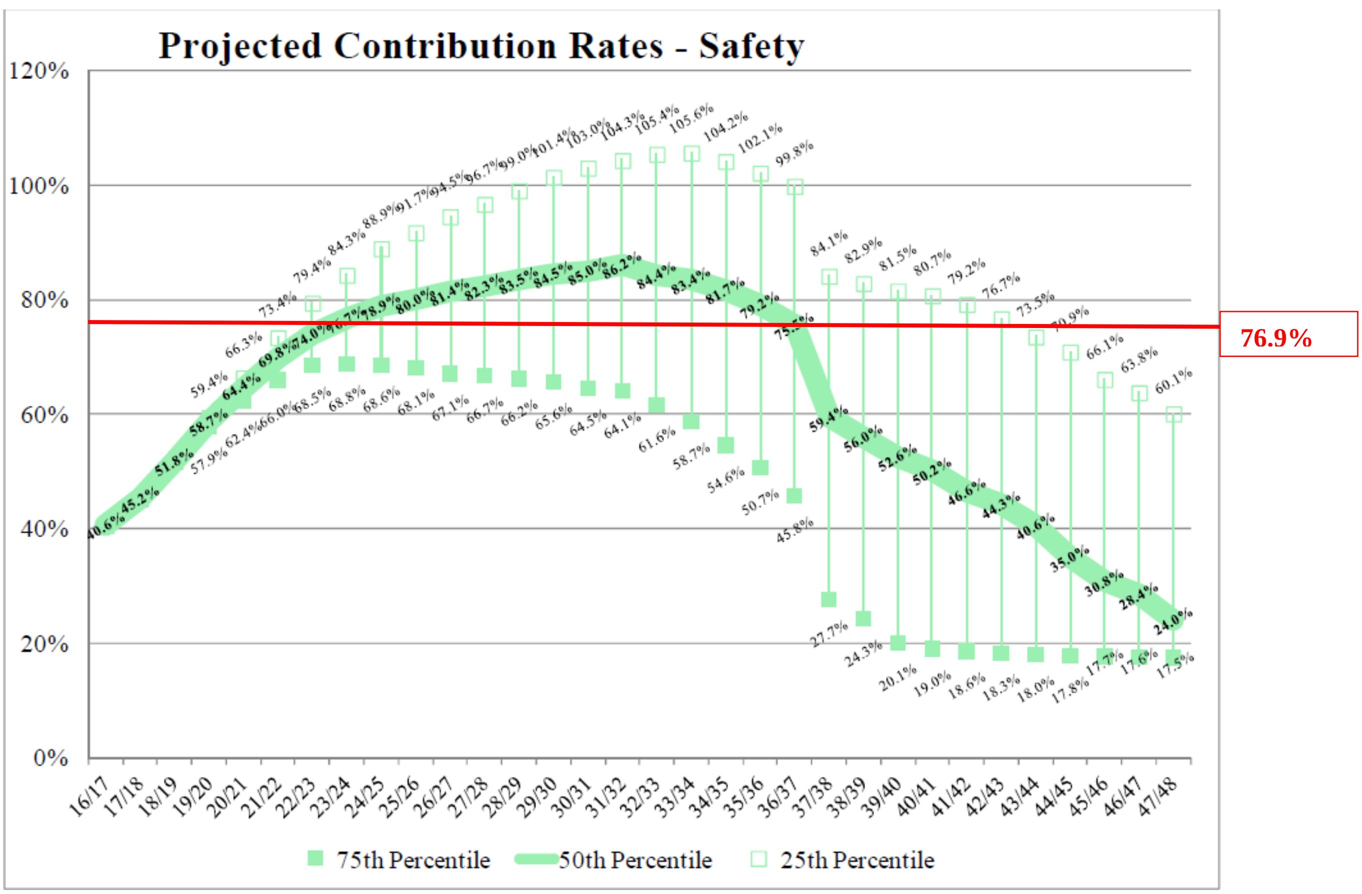
CONTRIBUTION RATES – SAFETY



Per these actuarial projections, the City's required employer contributions for the year ended June 30, 2028 will approach $13.5 million, compared with the $5.7 million required in the 2017-18 fiscal year. Such escalating payments would seriously encumber future-year budgets. The required employer rate for the Miscellaneous Plan is projected to peak at 42 percent of covered payroll in fiscal year 2027-28; the maximum rate projected for the Safety Plan (86.2 percent) is not reached until FY 2031-32. This means that, for every $100 of wages, the City will pay an additional $42 for a miscellaneous employee and $86 for a safety employee in pension expense. After attaining these peaks, rates will level off for a few years and then begin to decrease; the required employer rate for the Miscellaneous Plan (24.6 percent) and Safety Plan (45.2 percent) are projected to fall to current year rates by fiscal years 2041-42 and 2042-43, respectively.

In developing the budget for the 2017-18 fiscal year, Council requested amounts be set aside to begin pre-funding the City's pension obligations, especially in response to the sharply increasing rates projected by Bartel. Staff suggested that instead of merely funding at the current required employer rate for each fiscal year, the City set aside funding at a rate that would smooth the projected increased contributions to CalPERS over the next 10-15 years. To the extent that the amount expensed at the higher (threshold) rate exceeds the required contribution to CalPERS each year, the funds would be set aside to support funding required when rates climb above the threshold rate. The threshold rates established, based on the average projected rates from the current fiscal year until rates fall to current levels, are 37.7 percent for the Miscellaneous Plan and 76.9 percent for the Safety Plan. Again, this method of funding merely smooths out the *rate* (as a percentage of payroll) for the employer pension expense that will be included in each fiscal year's budget.


Projected Contribution Rate - Miscellaneous
60%
50%
40%
30%
20%
10%
0%
16/17
17/18
18/19
19/20
20/21
21/22
22/23
23/24
24/25
25/26
26/27
27/28
28/29
29/30
30/31
31/32
32/33
33/34
34/35
35/36
36/37
37/38
38/39
39/40
40/41
41/42
42/43
43/44
44/45
45/46
46/47
47/48
25th Percentile
50th Percentile
75th Percentile
37.7%


Projected Contribution Rates - Safety
120%
100%
80%
60%
40%
20%
0%
16/17
17/18
18/19
19/20
20/21
21/22
22/23
23/24
24/25
25/26
26/27
27/28
28/29
29/30
30/31
31/32
32/33
33/34
34/35
35/36
36/37
37/38
38/39
39/40
40/41
41/42
42/43
43/44
44/45
45/46
46/47
47/48
75th Percentile
50th Percentile
25th Percentile
76.9%

Alternative pre-funding mechanisms

Having established a systematic funding methodology for the amount of employer contribution that serves to smooth future rate increases (and pension costs), the City can now turn its attention to the various pre-funding mechanisms available.

1.) Make additional pension payments directly to CalPERS – CalPERS recommends this option for agencies who wish to minimize interest costs related to future liabilities. Of course, the options for accelerated funding of the CalPERS liabilities are only applicable to agencies who are not currently struggling to meet current and ongoing service obligations. The City has consulted its CalPERS actuary to develop these available options:

- **Fresh Start /Partial Fresh Start Program**. CalPERS recommends agencies accelerate their pension payments for unfunded liabilities to minimize interest costs related to future liabilities. This "Fresh Start" approach advocated by CalPERS requires paying off the unfunded annual liability (UAL) faster than the existing schedule in order to realize a new, higher minimum UAL payment. The entire UAL would be collapsed into a single base and amortized over a fixed period of years; the fixed period is chosen by the agency but cannot result in amortization payments less than the original schedule. The unfunded liability gap would be closed in that specific number of years. A “Partial Fresh Start” would allow the City to apply the payment to specific UAL bases only. (See details of the current UAL bases, amortized over a period of 10-30 years, below.) Paying down the shortest bases will have the largest immediate impact on the City’s future contribution requirements, while paying down the longest bases will save the most in interest over the long-term. Both options lead to additional contributions for a shorter period, improve stability of contributions over time, improve the funded status of the plan over time, and save money over the long-term when compared to the “baseline” of projected CalPERS employer contributions. However, once elected, the fresh start programs cannot be undone – the new (required) UAL payment schedule remains in place regardless of the City’s funding availability. Therefore, prior to participating in these options, agencies must be able to identify available revenues to make the accelerated payments.

- **Additional Discretionary Payments (ADP)**. Additional amounts (over the required employer contributions/baseline) may also be sent directly to CalPERS. The payment can be applied to any UAL base desired, but no changes in the UAL amortization periods are made, so no new required payment schedule is required. Although less future interest savings will be realized, electing to pay the unfunded liability on a discretionary basis preserves the City’s budget flexibility in the event of an economic downturn.

CALPERS ACTUARIAL VALUATION - June 30, 2015
MISCELLANEOUS PLAN OF THE CITY OF BURLINGAME
CalPERS ID: 1429123533

Schedule of Amortization Bases

There is a two-year lag between the valuation date and the start of the contribution fiscal year.

- The assets, liabilities, and funded status of the plan are measured as of the valuation date: June 30, 2015.
- The required employer contributions determined by the valuation are for the fiscal year beginning two years after the valuation date: Fiscal Year 2017-18.

This two-year lag is necessary due to the amount of time needed to extract and test the membership and financial data, and the need to provide public agencies with their required employer contribution well in advance of the start of the fiscal year.

The Unfunded Accrued Liability (UAL) is used to determine the employer contribution and therefore must be rolled forward two years from the valuation date to the first day of the fiscal year for which the contribution is being determined. The UAL is rolled forward each year by subtracting the expected payment on the UAL for the fiscal year and adjusting for interest. The expected payment on the UAL for a fiscal year is equal to the Expected Employer Contribution for the fiscal year minus the Expected Normal Cost for the year. The Employer Contribution for the first fiscal year is determined by the actuarial valuation two years ago and the contribution for the second year is from the actuarial valuation one year ago. The Normal Cost Rate for each of the two fiscal years is assumed to be the same as the rate determined by the current valuation. All expected dollar amounts are determined by multiplying the rate by the expected payroll for the applicable fiscal year, based on payroll as of the valuation date.

Reason for Base	Date Established	Amortization Period	Balance 6/30/15	Expected Payment 2015-16	Balance 6/30/16	Expected Payment 2016-17	Balance 6/30/17	Scheduled Payment for 2017-18
FRESH START	06/30/05	14	$1,762,713	$154,399	$1,734,832	$159,031	$1,700,057	$163,802
BENEFIT CHANGE	06/30/06	10	$223,329	$24,148	$215,041	$24,873	$205,381	$25,619
BENEFIT CHANGE	06/30/07	11	$2,491,881	$253,613	$2,415,821	$261,221	$2,326,168	$269,058
ASSUMPTION CHANGE	06/30/09	14	$4,760,501	$416,981	$4,685,203	$429,490	$4,591,288	$442,375
SPECIAL (GAIN)/LOSS	06/30/09	24	$1,943,364	$125,695	$1,958,794	$129,465	$1,971,471	$133,349
SPECIAL (GAIN)/LOSS	06/30/10	25	$493,091	$31,251	$497,671	$32,189	$501,622	$33,154
ASSUMPTION CHANGE	06/30/11	16	$2,407,017	$194,595	$2,385,783	$200,433	$2,356,904	$206,446
SPECIAL (GAIN)/LOSS	06/30/11	26	$(974,019)	$(60,565)	$(984,275)	$(62,382)	$(993,417)	$(64,253)
PAYMENT (GAIN)/LOSS	06/30/12	27	$375,227	$22,917	$379,608	$23,604	$383,606	$24,312
(GAIN)/LOSS	06/30/12	27	$1,962,404	$119,852	$1,985,319	$123,448	$2,006,225	$127,151
(GAIN)/LOSS	06/30/13	28	$14,558,897	$204,771	$15,438,503	$421,829	$16,159,029	$651,726
ASSUMPTION CHANGE	06/30/14	19	$6,169,658	$(42,665)	$6,676,619	$127,174	$7,045,508	$261,979
(GAIN)/LOSS	06/30/14	29	$(10,355,405)	$(8,502)	$(11,123,245)	$(156,449)	$(11,795,279)	$(322,285)
(GAIN)/LOSS	06/30/15	30	$3,197,746	$(2,243)	$3,439,903	$(2,846)	$3,700,847	$52,053
TOTAL			**$29,016,404**	**$1,434,247**	**$29,705,577**	**$1,711,080**	**$30,159,410**	**$2,004,486**

2.) Borrow from the General Fund – If funding is available, there is always the option to use unassigned reserves from the General Fund to accelerate pension payments. Similar to the Fresh Start approach described above, the City could use available General Fund balance to make accelerated pension payments directly to CalPERS. Although the additional payments would reduce the overall interest paid, anticipated repayment through interest savings (from all funds) is uncertain. As with all direct payments to CalPERS, funds are subject to CalPERS investment volatility. Burlingame's General Fund unassigned fund balance is anticipated to be at least $9.2 million at the end of the 2017-18 fiscal year. However, given the size of its unfunded obligations, the City's unallocated reserves would be quickly depleted if accelerated payments were to have any significant impact on long-term costs.

3.) Pension Obligation Bonds (POBs) – Many agencies are taking a fresh look at the issuance of POBs. However, the Government Finance Officers Association (GFOA) recommends that state and local governments *not* issue POBs due to the risks involved. The City already has pension obligation bonds outstanding from a September 2006 issuance of close to $33 million. Although an analysis of the issuance performed by Bartel Associates earlier this year concluded that the estimated reduction in CalPERS contributions is greater than the POB debt service thus far, there is no guarantee that this positive arbitrage will continue. In addition, the POBs have put a severe limitation on the City's debt capacity for these past ten years, a situation that the City would prefer not to duplicate.

4.) Internal Reserve – Placing funds in an internal reserve provides maximum flexibility to the City, as both the sources and uses of the funds are not set in stone. However, investments would be limited to the same restricted type of portfolio that is used for governmental funds, providing less interest earnings than if invested in a higher yield, higher duration portfolio. In addition, the accumulated assets would not offset the City's pension liabilities, as the funds could be redirected at any time.

5.) Section 115 Trust – Funds placed in an irrevocable pension supplemental Section 115 Trust would be restricted in use solely for pension obligations. However, such a trust would offer the following beneficial features:

- Act as a reserve fund to offset potential volatility in the CalPERS annual contribution or rate requirements
- Allow more control and flexibility in investment allocations
- Realize higher investment returns than by maintaining monies within the City's portfolio, which is restricted by State regulations to fixed income instruments
- Act as a set-aside and available for use in reducing the City's pension obligations

The trust fund as envisioned for use by the City of Burlingame would primarily be used for rate stabilization, but will likely not reduce GASB 68 Net Pension Liabilities. Because funding was established to provide a buffer against the higher employer contributions that are projected to be required in the next 10-15 years, the trust could be funded and then depleted over that period of time, with the same anticipated funding status as would have been achieved by paying at the required employer contribution (baseline) rate. However, it should be noted that funds from the trust can be used to make *additional* payments directly to CalPERS as well as the *supplemental* payments initially proposed.

Any of the above funding mechanisms would solidify the City's AA credit rating by demonstrating proactive action in meeting its long-term pension obligations. However, the 2017-18 fiscal year budget includes a $3.7 million transfer from the City's various operating funds to a reserve or fund created to smooth out the required employer contributions in future years. The staff recommends that a Section 115 Trust be established for this purpose, to optimize the interest earnings on the fund, while still allowing flexibility in the timing and sources to be used to fund the trust.

There are currently only two independent retirement plan administrators in California authorized to offer Section 115 Trusts, Public Agency Retirement Services (PARS) and Public Financial Management Group (PFM). Both administrators have received a Private Letter Ruling from the Internal Revenue Service, which assures participants of the tax-exempt status of their investments. Staff will examine the offerings of both PARS and PFM to determine which trust/plan best provides for the needs of the City.

Additional Future Strategies

To date, the City has focused on smoothing out its pension expense in upcoming years to avoid the very high cash outlays for pension costs that are projected as a result of the reduction in the CalPERS discount rate assumption. Immediately establishing the Section 115 Trust is especially important for the General Fund, which faces significant demands on its resources and is most sensitive to swings in its tax revenue sources. However, as noted in the discussions of the various funding mechanisms available, it may be prudent to incorporate other options into the City's pension strategy so as to more efficiently amortize the City's UAL balance with CalPERS in order to realize long-term savings from interest on these significant liabilities. Staff will continue working with its actuary and CalPERS to determine what further strategies would maximize interest savings. Although a Fresh Start will probably not be proposed, additional discretionary payments directed to amortization schedules of over 15 years would make significant headway in paying down the City's unfunded pension liabilities. These strategies will be visited with the FY 2017-18 mid-year budget analysis and report.

Education/Outreach Efforts

While providing direction as to the City's response to the CalPERS discount rate change and its impact on City costs, staff was tasked with developing messaging materials for employee groups, management, and the Council so that all parties involved, including the general public, can gain a concise and consistent understanding as to the impact of these changes on the City's long-term financial position. The discussion in this staff report should serve to kick off these efforts. The Human Resources and Finance Departments are in the process of boiling down the abundance of data and options to address the increased employer contribution rates going forward, and will be meeting with the City's various bargaining units and departments throughout the summer so that these impacts are clearly communicated to all employees. City employees have a vested interest in the health of the CalPERS system and the continued ability of the City to meet its pension obligations both in the short and longer terms.

FISCAL IMPACT

Once established, funds in the amount of $3.7 million will be withdrawn from the City's various fund balances (based on historic personnel cost ratios and established in the 2017-18 fiscal year budget) and transferred to a Section 115 Trust fund for the purpose of meeting employee pension obligations. Staff will provide further options for funding these obligations as part of the mid-year analysis.