



Staff Report

TO: City Council
FROM: Jennifer Ustation, Finance Director
DATE November 16, 2021
SUBJECT: Pension 115 Trust Options

Background and Analysis:

On March 3, 2020, the City Council received a presentation from Bartel Associates, LLC on the June 30, 2018, Valuation Preliminary Results. This report outlined that pension costs are very likely to increase and outpace revenue growth over the next twelve years. It is also projected that a recession coupled with growing needs is expected to create budget deficits by FY2024.

On March 16, 2021, the City Council approved to commit \$2,500,000 of unassigned fund balance in the General Fund toward the City's pension liability and to bring back options at a later date for a use of these funds. Beginning in FY2020, the City also started to pay its annual UAL payment upfront in July rather than paid monthly to save on interest costs. In FY2022, paying the upfront portion of the UAL payment saved the City \$49,594 in interest costs.

On September 21, 2021, the City Council was presented with an update on CalPERS Attachment A, which discussed the current unfunded liability, the recent trigger of CalPERS Funding Risk Mitigation Policy and where CalPERS is in their current Asset Liability Management process. CalPERS is in the process of reviewing different portfolio options which could possibly result in a drop in the current discount rate. On November 15, 2021, CalPERS will begin a three-day Board meeting where they will be scheduled to discuss changes to the discount rate.

At the September 21, 2021, meeting the City Council directed City staff to research pension 115 trust options, model financial scenarios and create a pension funding policy. This report will focus on the direction of research of pension 115 options.

Pension 115 Trust Benefits

A Section 115 trust is a tax-exempt investment vehicle authorized by the Internal Revenue Code (IRC) used to prefund essential government expenses (e.g., retiree medical and retirement plan benefits). To remain tax-exempt, assets held in a Section 115 Trust are designated as irrevocable, meaning they must be used to fund the City's retirement plan obligations. Additionally, monies held in such trusts can be invested in accordance with the rules governing those trusts, which are different than the investment rules for the City's pooled investments. Setting aside funds in a Section 115 Trust can potentially earn a higher rate of return than if funds were invested with the City.

Funds placed in a Section 115 Trust can remain in the trust until a point in time when the City chooses to draw on its assets to pay annual benefit obligations or reimburse the City for its pension expense. The City may withdraw funds by adopting policies and procedures that include requiring action be taken by City Council. The City would set its own restrictions on how and when the funds can be used and withdrawn.

Establishing a Section 115 Trust to prefund pension obligations is a best practice recommended by the Government Finance Officers Association (GFOA). Some of the other benefits that a Section 115 Trust program can provide are summarized below:

- City has complete local control over assets, including contributions, disbursements and the timing, amount, and risk tolerance level of investments;
- Assets can be transferred to the retirement system at the City's discretion and potentially reduce/eliminate large fluctuations in employer contribution amounts; and
- Can use deposited cash as an emergency source of funds in the event revenues are strained during difficult budgetary or economic times by reimbursing the General Fund for pension related obligations for current and prior year.

Pension 115 Trust Options

As directed by the City Council, City staff researched pension 115 trust options and found through other agencies' RFPs that there are very few options to choose from. The major players that offer pension trusts to meet the needs of the City are CalPERS, Keenan Financial, PARS and PFM. Attachment B is a comparison analysis of the options.

Option 1 – CalPERS

The CalPERS Pension 115 Trust, the California Employers' Pension Prefunding Trust (CEPPT), consists of two strategy investment options. The CEPPT is a self-funded, not-for-profit program where participating employers pay for the total costs of the trust option. The CalPERS program is managed by CalPERS (administrator), State Street Global Advisors (investment manager) and State Street Bank (trustee). The CEPPT has an all-inclusive fee rate of 25 basis points (0.25%) of employer account assets under management. There are no other fees. All employers pay the same fee rate, which may be higher or lower in the future per CalPERS. As of September 30, 2021, strategy 1 reported a one-year return of 13.43% while strategy 2 reported a one-year return of 5.82%. Termination requires 150 days advance notice and CalPERS Board approval.

Option 2 – Keenan Financial (MuniPST)

Keenan financial Services offers a Pension 115 Trust with 6 risk tolerance level portfolio choices. It is managed by Keenan Financial Services (administrator), Morgan Stanley (investment advisor) and Benefit Trust Company (trustee). The total management fees are 30 basis points (.30%) of assets under management. Keenan also utilizes a Board of Authority, which consists of a representative from each member agency (participation is not mandatory) to review the trust and provide advice regarding the investment outlook for the future. As of September 30, 2021, Keenan reported a one-year return rate ranging from 1.9% - 23.69% within their 6 portfolio options. Termination requires 90 days advanced notice.

Option 3 – PARS (1 of 2 Options)

The Public Agency Retirement Service (PARS) Pension 115 Trust includes 5 risk tolerance levels with choice of active or passive for a total of 10 risk tolerance options and can customize a portfolio valued at least \$5 million. (Passive investing means to hold at a representative benchmark whereas active involves constant attention to beat the benchmark). The trust is managed by PARS (administrator), HighMark Capital Management (investment advisor) and US Bank (trustee). HighMark Capital Management is a subsidiary of Union Bank; however, Union Bank is currently in the process of being acquired by US Bank. The total management fees are 60 basis points (0.60%) of assets under management. As of September 30, 2021, PARS reported a one-year return of 5.4% - 23.25% within their 5 active portfolio options. Termination requires 30 days advanced notice.

Option 4 – PARS (2 of 2 Options)

The second option for PARS is similar to the first but replaces the investment adviser with Vanguard. This is not normally an option for other agencies but was presented to the City when concerns with Union Bank were addressed due to past services with the City. This would only allow for a passive portfolio but would offer 4 different risk tolerance options. The one-year return reported ranged from (-.17%) - 21.84%. Termination is the same at 30 days advanced notice.

City staff contacted PFM and spoke with a representative as well as requested information. The representative informed staff that they felt they would not be a good option for the City as they have a minimum annual fee of \$25,000 and are currently not taking any new clients until March 2022 because of the transition process to a new trustee. As of the writing of this report the information requested to complete a comparative analysis has not been received.

City Staff Recommendation

While all four options can provide adequate services, City staff's determination and evaluation process concluded that PARS (1 of 2) option 3 would provide the best overall value for the City. PARS has extensive experience with pension trusts with a higher level of service provided with administering the trust, including assistance with developing an investment policy, funding recommendations along with the flexibility of investment options offered through HighMark Capital. Additionally, PARS is partnered with U.S. Bank, the trustee and plan fiduciary for safeguarding member assets, and provides for mutual indemnification in their member agreement, which the other providers do not. It should also be noted that if the City is not satisfied with the service provided, the termination process is quicker than the other providers, only requiring a 30-day notice.

Given the high level of service and responsiveness given to its members, City staff has concluded that having PARS as the Trust Administrator will be less demanding of Finance staff time and minimize impacts to ongoing project and responsibilities. City staff reached out to references and received positive reviews of PARS. Clients were satisfied with the service being provided, due to PARS being easy to work with, its responsiveness, and the ongoing reporting provided. PARS will provide monthly, quarterly, and semi-annual reports on performance activity of the trust.

Next Steps

If the City Council supports the recommendation of option 3 then the next step would be to invite PARS to present to the City Council, authorize establishment of the PARS Trust and appoint a Plan Administrator. Once the account is established City staff can begin to work with PARS on developing a specific investment policy statement and procedures, model financial scenarios and develop a funding strategy for future contributions to the trust that will serve as the underlying investment guide to the City's account. The investment policy and funding strategy will be reviewed by City Council with recommendation for adoption.

Fiscal Impact:

City staff estimated the cost to prepare this staff report to be \$2,925.

Recommended Action:

Discuss the options provided for Pension 115 Trust and direction to City staff.

Attachments:

- A. September 21, 2021, CalPERS Pension Update Presentation
- B. Pension 115 Trust Comparison Analysis
- C. Portfolio Updates as of September 30, 2021, for all options
- D. PARS Pension Rate Stabilization Plan (PRSP) Client List