Office of the City Manager

June 25, 2018

To: Honorable Mayor and Members of the City Council

From: DWR Dee Williams-Ridley, City Manager

Subject: Response to Questions Posed by the Council Budget Committee RE: Establishing a Section 115 Trust and Update on Certain General Fund Revenue Sources

BACKGROUND

The Council Budget Committee met on June 15, 2018 and requested an off-agenda memo that responds to the following questions about the IRS Section 115 Trust that staff is bringing to Council on June 26, 2018.

Questions Asked by the Budget Committee Related to Establishment of an IRS Section 115 Trust

On the agenda was a discussion on the 115 Trust Fund. The committee reviewed the June 26 Council report Authorization to Establish IRS Section 115 Trust Fund and Appoint the City Manager as the Plan Administrator (Item #19).

1. ***Investments earning – When CalPERS investments increase will the investments in the Trust decrease?***

   If the question the Committee is asking is if CalPERS starts consistently earning higher rates of return than the discount rate (currently 7%) and, thereby, increasing the City's funding ratios, will the City be able to make fewer contributions to the Section 115 Trust? The answer is that the closer the City gets to 100% funding of the pension obligations, the less additional money needs to be set aside. However, that is a big if, since CalPERS hasn't consistently exceeded expectations in the past, even with very hot stock markets and real estate markets.

2. ***How does the Trust work? Is the Trust a reimbursable Trust (reimburses the City for expenditures) or does the City just make a direct payout to PERS?***

Once contributions are placed into the Section 115 Trust, assets from the Trust can be used for specific benefit plan purposes including:

a. Reimbursing the City for pension contributions.
b. Transferring assets directly to CalPERS.
c. Paying pension plan expenses (actuarial valuation or audit expenses)

3. How do we benefit from the trust?

Some of the significant benefits of establishing a Section 115 Trust are the following:

a. **City Control**: The City maintains complete control over the assets in the Trust, as opposed to sending the money directly to CalPERS to address unfunded pension obligations. The City loses control or oversight over the funds forever once the funds are sent to CalPERS, and CalPERS handles everything.
   For example, CalPERS recently increased the risk in its investment portfolio. CalPERS has a relatively risky asset allocation. Specifically, CalPERS new portfolio asset allocation announced on December 18, 2017 is 63 percent invested in equities and real estate (50% in global equities and 13% in real assets), and these two asset classes are very vulnerable to an economic downturn.
   With a Section 115 Trust, the City can determine the level of risk taken in the investment portfolio and can determine the Trust's asset allocations.
b. **Pension Rate Stabilization:** Assets can be transferred to CalPERS at the City's discretion, which will help reduce or eliminate large fluctuations in employer contributions towards retirement benefits.
c. **Investment Flexibility and Investment Management:** The Trust permits the City, under federal and state law, to invest in a more diversified array of appropriate investments to maximize returns on long-term investments, and reduce the City's liability; and Investment of plan assets can be managed by a professional fund management team, selected by and monitored by City staff.

4. What is the recommended annual contribution to the Trust and suggested funding source (the Committee would like to discuss this)?

The Council report submitted for June 26, 2018 only deals with the establishment of the Section 115 Trust and not the funding for the Trust. The initial seed money for the Trust fund will come from the balance in the PERS Savings Fund, which is currently about $4 million. Staff had planned to come back to Council at a later date with recommendations for the ongoing annual funding of the Trust. However, since the Budget Committee asked the question, staff recommendations might include the following for the ongoing annual funding of the Section 115 Trust:

a. The first $1 million of the excess Property Transfer Tax over the base of $12.5 million established by Council;
b. One half of the total salary savings each year (FY 2018 projected total is $2,230,555);

5. ***How much will the City have to place in the Trust (annually) to significantly impact our unfunded liabilities?***

   That's a tough question to answer, without calculations from the City's actuary. Any amount consistently contributed in excess of the required contributions to CalPERS and invested at a higher rate of return will help reduce the size of the pension obligation. The more the City contributes, the more it will earn on its investment portfolio, and the more impact the contributions and earnings will have on reduction of the outstanding pension obligation. Some cities are making large one-time contributions, but don't seem to have a plan beyond that. Berkeley should implement a plan for making significant annual contributions to the Trust, and adding any one-time contributions when surplus moneys become available.

6. ***What are the various investment mixes offered by the Trust?***

   According to Section 53216.1 and 53216.6 of the California Government Code, the Council may authorize investment in any form or type of investment deemed prudent by the Council, solely in the interest of, and for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.

   That said, staff expects the professional investment management firms to offer a variety of mutual funds, indexes, and exchange traded funds, where the percentage of equity varies depending on the City's investment objectives and risk tolerance (e.g., Conservative, moderately conservative, moderate, balanced, and capital appreciation).

7. ***How can we fund our other OPEB unfunded liabilities (retiree medical)? What tools are available?***

   The City has retiree medical trusts in place that are managed by the City. We are submitting a report to Council on June 26, 2018, requesting that the investment policy for these OPEB trusts be severed from the City's investment policy for idle pooled cash, which are severely restricted.

   The OPEB trusts belong to the employees and investments should not be restricted in the same manner as the City's relatively short-term funds, since pension obligations are long-term in nature. One option that can be taken to potentially help increase the City's resources to fund OPEB trusts is to invest a portion of the portfolios in equities, and contract with professional fund management teams to manage the investment portfolios. In addition we fund the OPEB trusts in accordance with the MOUs. How to fully fund these trusts should be part of future negotiations.

8. ***What are some other jurisdictions that have similar trusts (CalPERS) and how much do they place in their trusts annually?***

Following are examples of policies/methods used by other cities to fund their Section 115 Trust funds:

SAMPLES OF FUNDING POLICIES/METHODS	
City	**Funding Policies**
Solana Beach & Alameda	Contribute 50% of a given year's realized year-end surplus to address pension liability.
Brea	Contribute amount equal to annual PERS employer contribution ($6 million) in order to allow full access to trust assets at all times.
Healdsburg	Contribute $4 million to stabilize PERS employer Misc. rates to 28% and Safety to 44% through FY 23-24.
Huntington Beach	"One equals five plan": Contribute $1 million per year for 5 years based on premise that every contribution will save taxpayers $5 million over 25 years.
Sausalito	Contribute employer contribution equal to the 2.8% discount rate (as opposed to the standard 7.5% rate), with difference going into the Section 115 Trust.
Redwood City	$10.5 million one-time contributed plus it maintains a 15% General Fund reserve and is targeting to make contributions over and above that threshold into the Trust.
Fountain Valley	Earmarked a portion of a recently approved local sales tax measure to be set aside for unfunded pension liabilities.
Pasadena & West Covina	Using one-time revenue source plus ongoing savings from CalPERS unfunded liability pre-payment.
Glendale	Using one-time revenue source and lowering the minimum General Fund reserve level from 30% to 20%. Transferred $26.5 million as the initial contribution in FY 2018. Additional

	contributions of $5 million and $3.5 million are to be made in FY 2019 and FY 2020, respectively.
Emeryville	$9.6 million one-time amount will be contributed by August 31, 2018; future contributions depend on the amount of future available one-time money.
Pleasanton	Very soon plans to contribute one-time amount of $28 million, 70 percent to be invested in equities and 30 percent in fixed income securities.
Stockton	$21.2 million one-time amount contributed; has transferred budgeted salary savings directly to CalPERS. May transfer them to Section 115 Trust in the future.

cc: Jovan Grogan, Deputy City Manager
Mark Numainville, City Clerk
Matthai Chakko, Assistant to the City Manager
Ann-Marie Hogan, City Auditor
Henry Oyekanmi, Director of Finance
Teresa Berkeley-Simmons, Budget Manager