City of Culver City

Mike Balkman Council Chambers
9770 Culver Blvd.
Culver City, CA 90232

Staff Report

File #: 18-0971, **Version:** 2 **Item #:** A-6.

CC - (1) Approval of a Professional Services Agreement with PFM Asset Management, LLC to Establish and Administer a Supplemental Pension Trust and (2) Approval of a Proposed Budget Amendment (Four-Fifths Vote Requirement).

Meeting Date: March 12, 2018

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Fiscal Impact: Yes [X] No [] **General Fund:** Yes [X] No []

Public Hearing: [] **Action Item:** [] **Attachments:** Yes [X] No []

Commission Action Required: Yes [] No [X]
Commission Name:

Public Notification: (E-Mail) Meetings and Agendas - City Council (03/06/17)

Department Approval: Jeff Muir, Chief Financial Officer (03/01/18)

RECOMMENDATION

Staff recommends the City Council approve a professional services agreement with PFM Asset Management, LLC to establish and administer a supplemental pension trust and approve a related budget amendment **(budget amendment requires a 4/5ths vote)**.

BACKGROUND

The City of Culver City has two pension trusts with the California Public Employees' Retirement System (CalPERS): one to fund public safety employees and one for miscellaneous employees. The trusts are funded by employer and employee contributions and by investment earnings on those contributions. In order to reach necessary funding levels to pay employee pensions, CalPERS establishes a set of actuarial assumptions to achieve those levels.

One of the most critical assumptions 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 and employees will have to increase.

While investment returns for CalPERS have always varied from year to year based on the market, the Great Recession hit the system hard and recovering from those losses, as well as other actuarial assumption changes, is going to be costly for the City for the foreseeable future. While the ROR for FY 2017 was 11.2%, it was not achieved in the prior 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.

3 years	4.6%
5 years	8.8%
10 years	4.4%
20 years	6.6%

As a consequence of the above performance; a long, low interest rate environment; and movement toward a more “risk averse” portfolio; the CalPERS board has approved a plan to reduce the assumed ROR from 7.5 percent to 7.0 percent over a three year period. The ROR assumption used in PERS actuarial reports will decrease as follows: reports as of June 30, 2017 to 7.375 percent; reports as of June 30, 2018 to 7.25 percent; and in reports as of June 30, 2019 to 7.0 percent.

CalPERS’ gradual decrease in the ROR assumption will result in higher contribution rates for employers and employees. This will compound existing funding challenges since the two City trusts already are below the ideal level of at least 80 percent funded. The miscellaneous group stands at 67.0 percent and the public safety group stands at 61.6 percent. As the ROR decreases, these funding levels will drop placing the City further behind in meeting pension obligations.

As a consequence of the above factors, staff is trying to develop options to address unfunded pension liabilities and specifically directing General Funds to a tax-exempt Section 115 Trust for pension costs.

DISCUSSION

Culver City’s current policy is that 30% of General Fund operating expenditures will be maintained as a contingency reserve. As of June 30, 2017 this amount was $31.9 million. Additionally, as of June 30, 2017 there was an additional $22.6 million of undesignated General Fund balance. Staff is recommending that $10 million of these excess reserves be an initial deposit into the trust. Staff is also recommending that the City plan to leave these funds on deposit in the trust for at least ten to fifteen years in order to maximize the power of compounding interest. The City is very limited by State law as to how municipal funds can be invested. The current resulting interest earnings are approximately 1.5%. A Section 115 pension trust is able to broaden the investment vehicles to equities, bonds and other opportunities in order to achieve a higher expected return. The trust would target an earnings rate between 5% and 6%. This recommendation has been discussed with the Finance Subcommittee and both members concurred. The table below illustrates the power of compounding interest assuming a $10 million initial investment that has annual earnings of 1.5%, 5%

or 6%:

	1.5%	5%	6%
At 10 years	$11.6M	$16.3M	$17.9M
At 15 years	$12.5M	$18.8M	$21.3M
At 20 years	$13.5M	$26.5M	$32.1M

By proactively establishing a 115 trust, the City will prefund pension costs and begin to address GASB 68 Net Pension Liabilities (NPL). While these trust funds must be dedicated toward pension obligations, they serve multiple purposes such as:

- Act as a reserve fund to offset potential volatility in 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 that is restricted by State regulations to fixed income instruments
- Diversifies investments in pension and retiree medical trusts
- Act as a set-aside and available for use in reducing the City's pension obligations

Staff recommends implementing the trust for all City funds. As of June 30, 2016 (the latest actuarial valuation from CalPERS, which is in arrears), the unfunded pension liability totals $226.5 million for all funds. The General Fund's proportional share of the total is approximately $187.2 million or 82.7 percent. The trust will then maintain a sub account for each City fund having a pension liability.

This allows specific contributions by fund for its share of the unfunded liability. With Council authorization, a deposit of $10 million will be made to the General Fund sub account. Staff would then return during the FY 2019 proposed budget process with any recommendations for additional funding by other funds. In addition to surpluses from these funds, it may be necessary to increase enterprise fund rates or fees to increase their sub-accounts within the Trust.

Establishing a pension trust is especially important for the General Fund (GF) which faces significant demands on its resources and is most sensitive to swings in its tax revenue sources.

For example, if the annual GF pension contribution is $14 million in a fiscal year and a $2 million deficit surfaced in that year, the General Fund, with Council's approval, could draw upon the GF trust balance to send $2 million directly to CalPERS and reduce the GF payments to PERS by $2 million. This would balance the budget and provide time to make informed decisions on fixing a one-time or ongoing budget deficit.

In addition to instituting a trust, staff will return to Council with recommendations on how to more aggressively address the ongoing growth in the City's unfunded pension liability by making additional payments to CalPERS. This will result in shortening the amortization period and significant interest cost savings over the long-term. One option is to allocate some portion of any year-end excess revenues. Discussions along these lines could occur at year end with allocations dependent upon needs at that time. Another option may be an additional revenue source that can be focused on reducing the unfunded liability. Action during this period is critical in light of CalPERS' newly adopted

ROR dropping to 7.0 percent over the next three years and as CalPERS costs to the City increase.

The Finance Department released a Request for Proposals in December 2017 with responses due on January 11, 2018. The two following firms submitted responsive proposals:

1. PARS
2. PFM Asset Management LLC (PFM)

Both firms have significant experience and meet the criteria to provide the required services. The City currently has an Other Post-Employment Benefits (OPEB) Trust with PFM. PFM's pricing proposal permits the balance of the existing OPEB Trust to count towards the tiered pricing, meaning the Section 115 Pension Trust will be charged the lowest tier cost of 22.5 basis points. Therefore, PFM is the lowest cost proposal to the City and staff recommends utilizing PFM to establish and manage the Section 115 Trust.

Staff will work with PFM to develop and execute the necessary documents to establish the Trust. Staff recommends targeting a return rate in the range of five to six percent, which would be a moderately conservative target. The specific target will be determined after further consultation with PFM.

FISCAL ANALYSIS

Compensation to PFM will be 0.225% of the trust balance. The City will also incur $6,000 per year in trustee fees. The costs of the trust will be paid directly out of the trust.

Funds in the amount of $10 million will be withdrawn from the General Fund undesignated balance and transferred to a Section 115 Trust fund for the purpose of meeting employee pension obligations. Staff will provide further funding options for the other Funds as part of the FY19 Proposed Budget.

ATTACHMENTS

None

RECOMMENDED MOTIONS

That the City Council:

1. Approve a professional services agreement with PFM Asset Management LLC to establish and administer a Section 115 Irrevocable Pension Trust, and

2. Authorize the transfer of $10 million of General Fund undesignated fund balance to the Trust and approve the related budget amendment **(budget amendment requires a 4/5ths vote)**; and

3. Authorize the City Attorney to review/prepare the necessary documents; and,

4. Authorize the City Manager to execute such documents on behalf of the City.