



STRATEGIES FOR MANAGING INCREASING PENSION & OPEB LIABILITIES

Meet the Panelists



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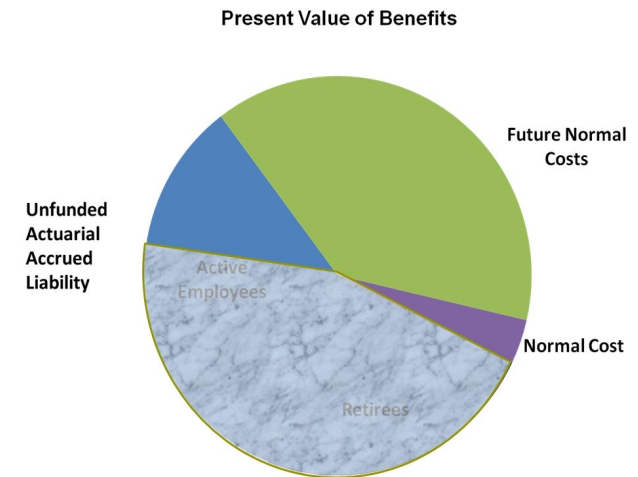


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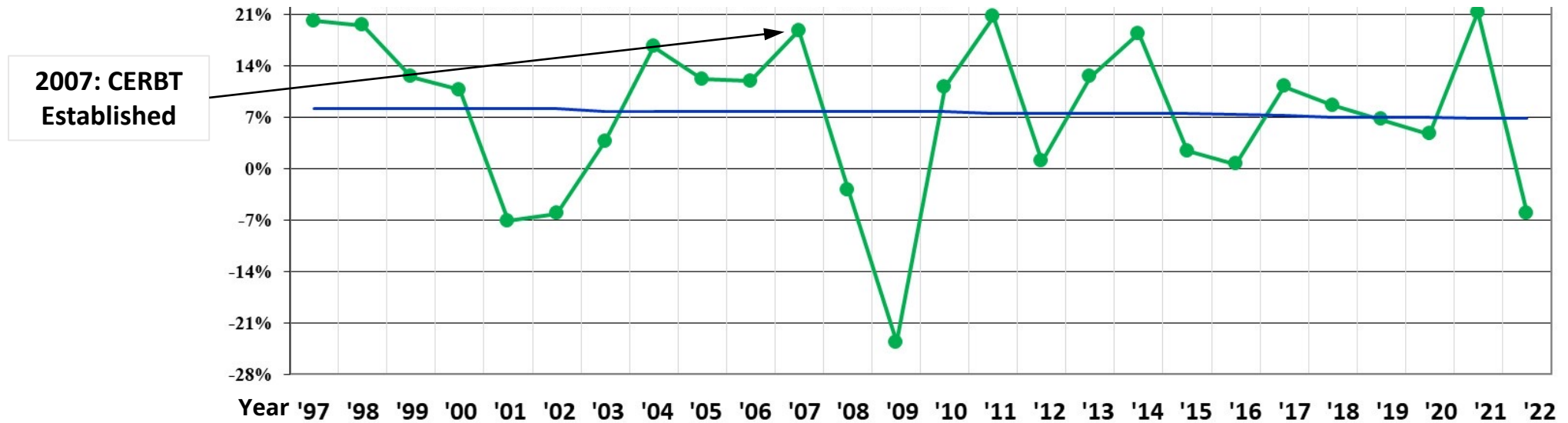
Let's Set the Stage

- Long-Term Liabilities:
 - Pension Plan – Monies paid after an employee's retirement that are not OPEB
 - OPEB (Other Post-Employment Benefits) Plan – Usually related healthcare or disability
 - Defined Benefit Plan – Retiree payment is defined by a document or formula and is not equal to the balance in an account
- These liabilities must be accrued, accounted for, and planned for
 - Why?

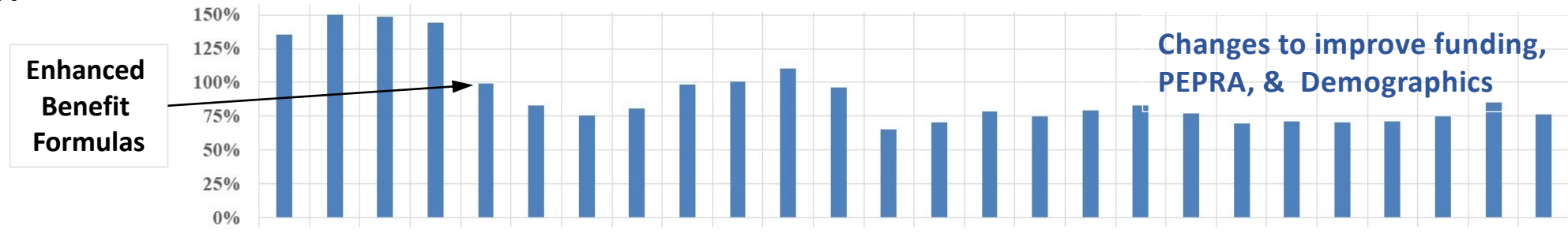


History

Annual Return on CalPERS Assets

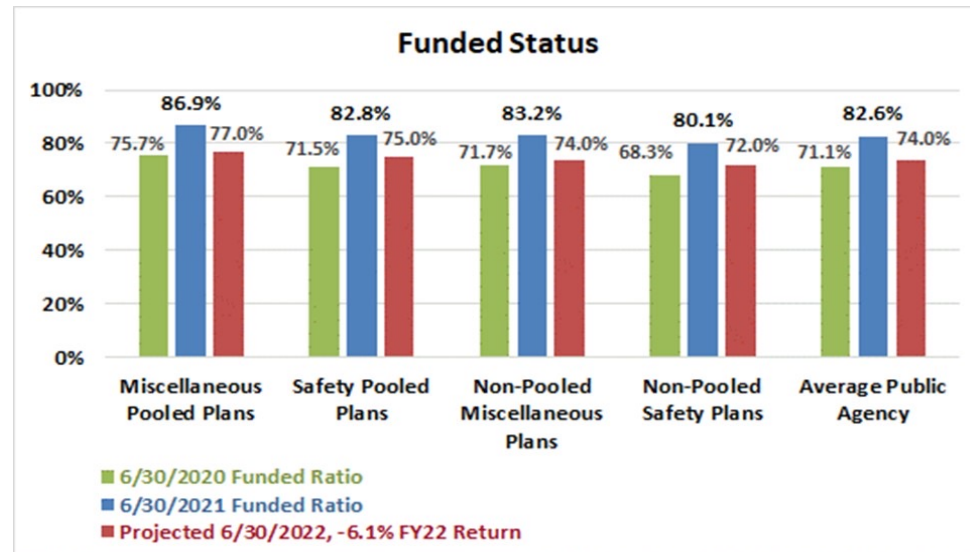
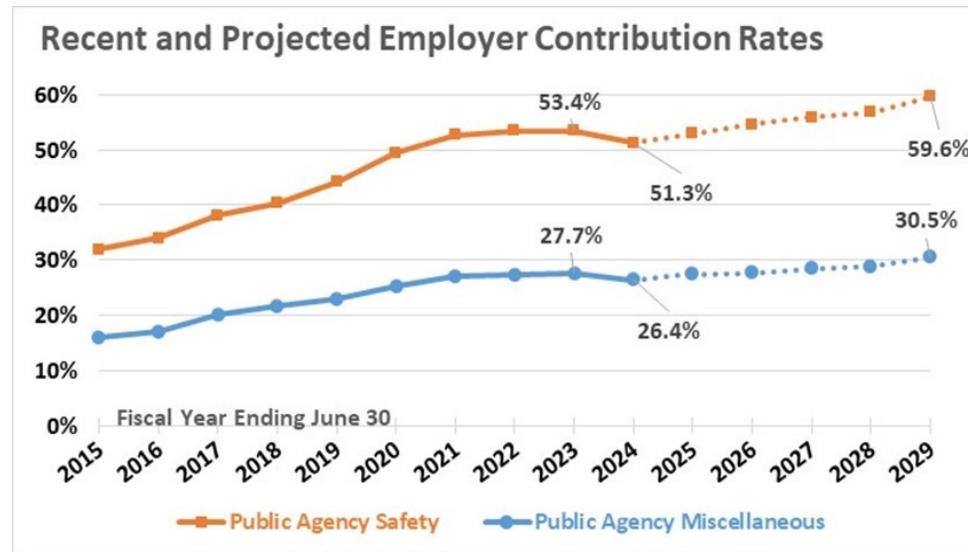


Typical CalPERS Plan Funded Status



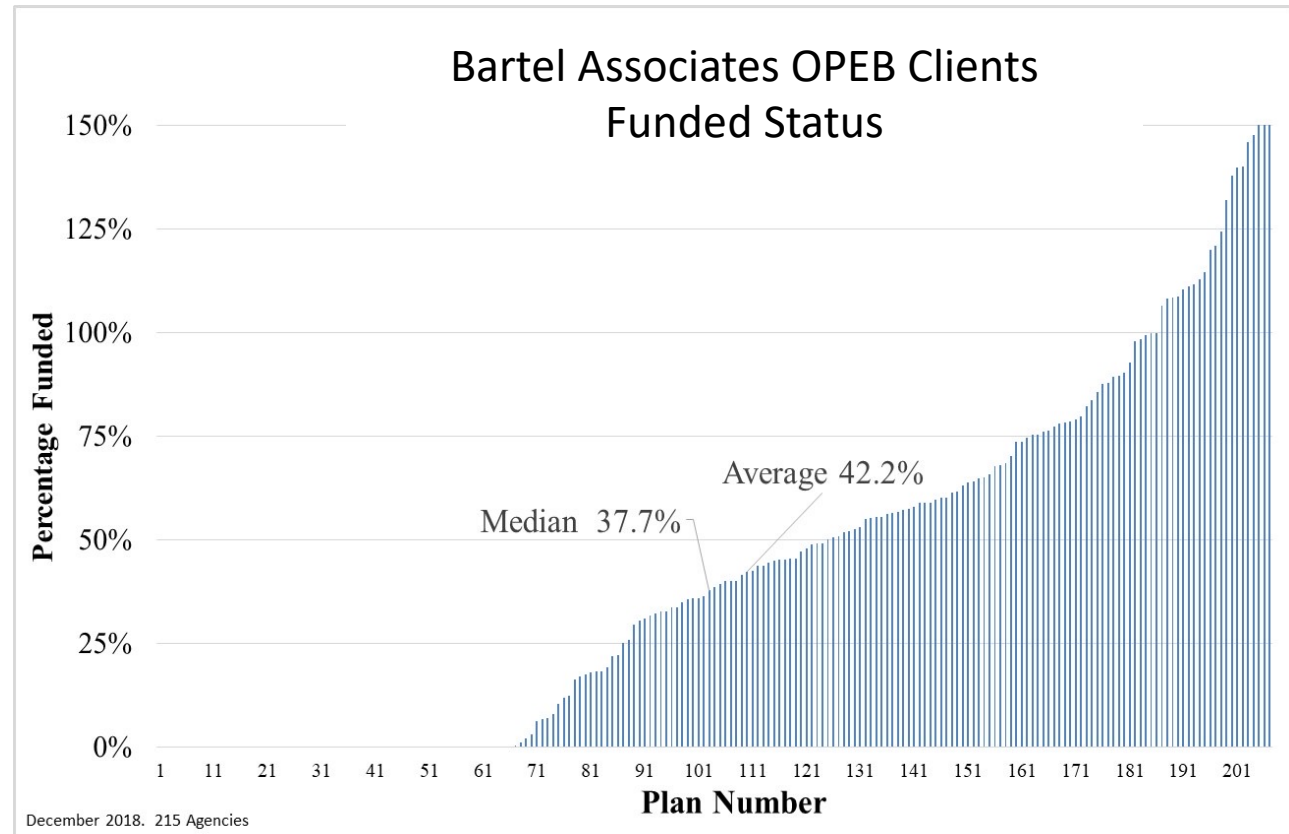
Where We Are Now - Pension

- Risk mitigation lowered discount rate, but CalPERS portfolio is more risky
- CalPERS new demographic assumptions increase costs & liabilities
- 2022 funded status will decline while projected contributions increase



Where We Are Now - OPEB

- More agencies are prefunding OPEB liability
- Impact of COVID, Inflation, Supply Chain
- Expect short-term premium/liability increases



Unfunded Actuarial Liability

- The UAL can be thought of like a fixed rate mortgage:
 - Amounts are growing with interest because they are future benefits discounted to today → looks like an interest “charge”
 - Because it’s the difference of 2 large numbers, small changes in assets or liabilities can make a large difference in UAL
 - UAL can never be paid off; it can always re-appear if there is an unexpected change in either the assets or liabilities

Unfunded Actuarial Liability

- What do actuaries mean when we talk about risk?
 - Biggest risk is future investment return – we expect a lot of future volatility
 - Impact of investment return on contributions
 - Other Pension and OPEB risks:

Inflation	Long-COVID	More mobile
Mortality/Longevity	“Great Resignation”	workforce
COVID-19	Healthcare Costs	
- Prefunding can’t eliminate or reduce impact of these risks that act on liabilities
 - Prefunding increases the amount of investment loss in a bad market, but the fund balance will almost always be higher than if no prefunding occurred.

5 Questions to Ask Your Actuary

1. Are there any actuarial assumptions used in the valuation that reflect my agency's plan in particular, and if so, how confident are you that those assumptions will prove to be correct in the short and long term, and what if they are not?
2. What can be done to reduce the actuarial liabilities of my agency's plan, for example changes in the plan design or cost sharing, and roughly how big could the reduction be? Also, discuss any features that make my plan more or less generous than common in plans.
3. What happens if my agency needs to take a break from prefunding pension and OPEB liabilities for a year or two?
4. What factors do you think could be the drivers of large future cost increases in the short term and long term and how are these taken into consideration in the valuation?
5. How well funded do you think my agency's plan should be and why, and what should the funding strategy be when we reach that target?

What Can Be Done?

Options for Funding Pension Liabilities:

- 1 Make Additional Discretionary Payment
- 2 Prefund into a Contingency Reserve Fund
- 3 Issue Pension Obligation Bonds/Certificates of Participation
- 4 Prefund into an IRS Section 115 Pension Prefunding Trust
- 5 Use Above In Combination with Each Other

Background: Pension

- Since 2015, GASB 68 has required disclosing Net Pension Liability on financial statements as a line item on the balance sheet.
- Before the concept of pension prefunding, the only way to reduce retirement system unfunded liabilities was to send additional contributions in excess of annual required employer contributions.
- Pension trust prefunding assets can be transferred to the retirement system at the Agency's direction, which can help offset future rate increases (i.e., pension rate stabilization).

CalPERS Changes

CalPERS has announced changes directly affecting unfunded liability amounts and employer contributions:

Lowering of Discount Rate ¹

7.0%



6.8%

CalPERS lowered the discount rate from 7.0% to 6.8%. The impact is reflected in the June 30, 2021 valuation reports.

¹ Contributions from policy changes beginning FY 23-24.

Shortened Amortization Period ²

30 years



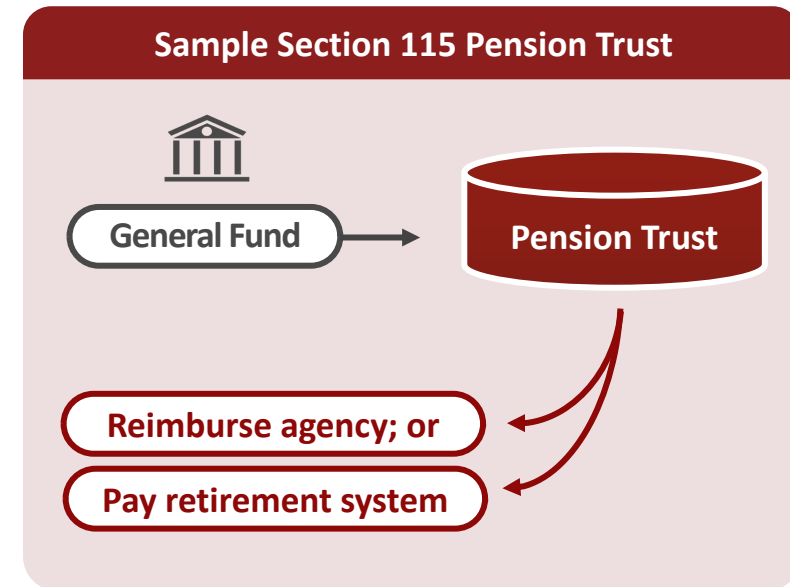
20 years

New actuarial liabilities are amortized over 20 years instead of 30, increasing required annual employer contribution amounts*

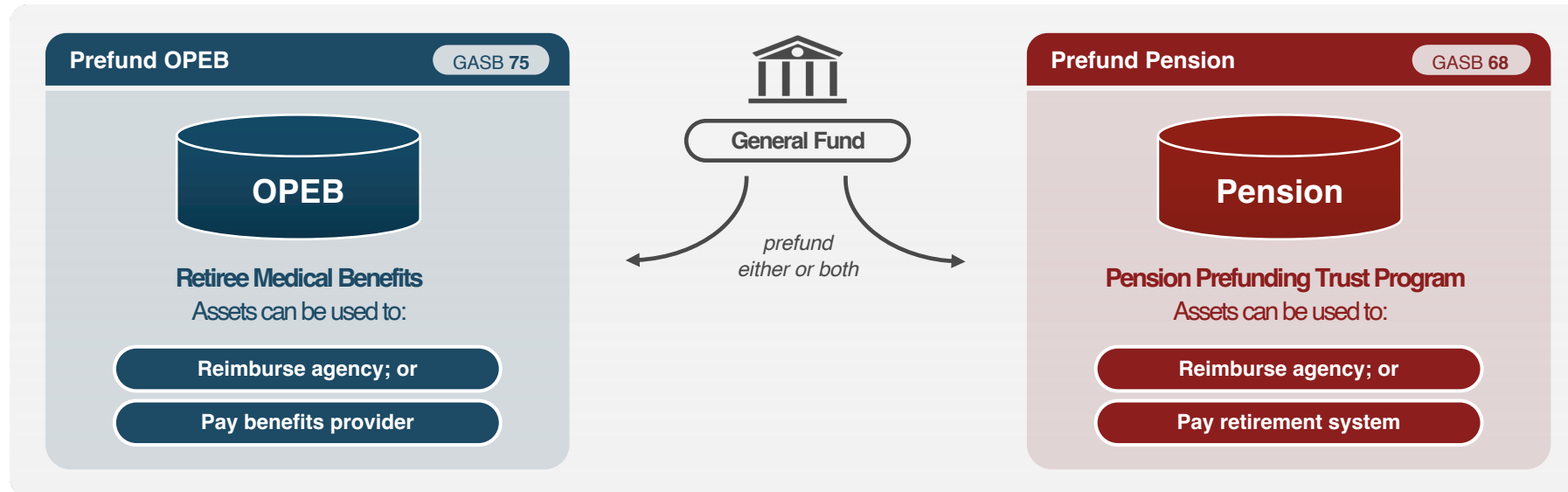
² 5-Year ramp up in payments beginning FY 15-16 with full impact in FY 19-20.

What are Section 115 Pension Prefunding Trusts?

- Section 115 Trusts can be used by local governments to fund essential government functions (i.e., retiree healthcare, pension).
- In 2015, GASB 68 required disclosing the Net Pension Liability as a line item on the balance sheet.
- In 2015, the nation's first Section 115 Combination Trust (to prefund both pension and OPEB) was established and received the first IRS Private Letter Ruling (PLR) on multiple employer basis.
- A PLR ensures tax qualified status whereby any income derived is tax exempt.



How Can a 115 Trust Be Structured?



Subaccounts

OPEB and pension assets are individually sub-accounted, & can be divided by dept., bargaining group, or cost center



Anytime Access

Trust funds are available anytime; OPEB for OPEB and pension for pension.



Flexible Investing

Allows separate investment strategies for all OPEB and pension subaccounts.



Financial Stability

Assets can be used to address unfunded liabilities

Why Prefund Pension Obligations?

01

Stabilize Costs

Access funds to reimburse your agency for pension-related expenses to help offset rising pension contribution rates

02

Local Control

Agency maintains autonomy over assets, contributions, disbursements, timing and investment risk tolerance

03

Protection

Funds in the trust are securely set-aside and protected from diversion for uses other than pension

04

Diversified Investing

Assets in an exclusive benefit trust can be diversely invested and may achieve greater returns than your general fund/treasury pool

05

Rainy Day Fund

Emergency source of funds when employer revenues are strained in difficult budgetary or economic times

06

Long-Term Planning

Prudent solution for managing ongoing pension liabilities on financial statements due to GASB 68

Why Prefund OPEB Obligations?

1. Contributions are **considered assets** on financial statements (GASB 75)
2. Assets in the trust **can be diversified for a potentially greater rate of return**
3. Actively addressing future obligations can **favorably impact credit ratings**
4. Prefunding can help **hedge against health care inflation, longer life expectancies** for retirees and the “baby boom” retirement surge
5. Prefunding now means that future taxpayers/employers **will not bear a disproportionate burden of costs**
6. Funds put into an OPEB Trust are dedicated for future OPEB costs and are protected **from diversion for other uses**
7. Prefunding helps to **offset the financial impact of GASB 75**
8. **GFOA recommends OPEB prefunding** and considers it “best practice” since 2012.

Why Use a 115 Trust vs. Reserve Account?

115 Trust	Reserve Account
Fixed Income or diversified investing available	Fixed income investing only
Can be tailored for short or long term	Investments not tailored for long term
Opportunity to earn greater return than General Fund	Conservative returns
Irrevocable (for non-pension expenses)	Revocable
Dedicated solely for pension costs	Can be accessed for other uses
Exclusive benefit/protected from creditors	Unprotected from creditors
Corporate trustee to mitigate fiduciary risk	No corporate trustee

Investment Flexibility

- Agency maintains oversight of the investment manager and the portfolio's risk tolerance level
- Investment restrictions that apply to the general fund (CA Government Code 53601) are not applicable to assets held in Section 115 Irrevocable Trust
- Assets held in Section 115 Irrevocable Trust can be invested per Government Code Sections 53216 (Pension) and 53620 (OPEB)
- Investments can be diversified and invested in a prudent fashion
- Investments can be tailored to the Agency's unique demographics and needs
- Increased risk diversification



Diversified Investing

Assets held in Section 115 Irrevocable Trust can be diversely invested in a prudent fashion per Government Code Sections 53216 (Pension) and 53620 (OPEB).

GOV § 53216 (Pension)

GOV § 53620 (OPEB)

Sample Portfolio Returns

As of September 30, 2022

HIGHMARK CAPITAL MANAGEMENT – ACTIVE PORTFOLIO RETURNS

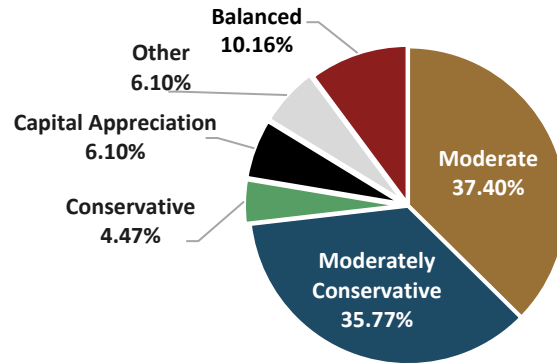
Strategy	Equity (%)	1 Year	3 Years	5 Years	10 Years
Capital Appreciation	65-85%	-16.95%	3.43%	4.57%	7.03%
Balanced	50-70%	-16.46%	2.47%	3.79%	5.93%
Moderate	40-60%	-15.92%	1.69%	3.20%	5.10%
Moderately Conservative	20-40%	-14.98%	0.00%	1.91%	3.51%
Conservative	5-20%	-14.21%	-1.23%	1.01%	2.35%

** Past performance does not guarantee future results.*

Investment Selection Choice – Pension & OPEB

Pension

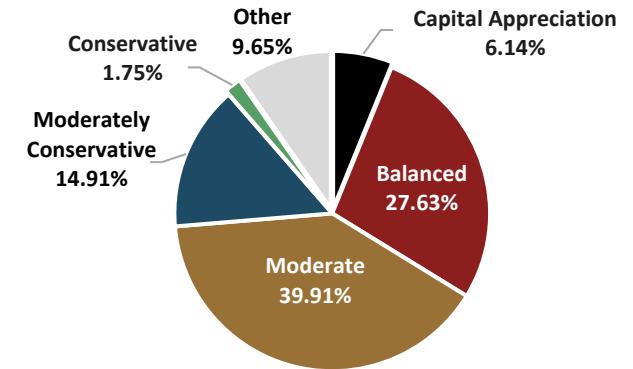
Active Platform: 55%
Passive Platform: 45%



HighMark Capital Management Strategy		Allocation* (%)
Capital Appreciation	(65-85% Equity)	6.10%
Balanced	(50-70% Equity)	10.16%
Moderate	(40-60% Equity)	37.40%
Mod. Conservative	(20-40% Equity)	35.77%
Conservative	(5-20% Equity)	4.47%
Other	(Custom)	6.10%
TOTAL		100.00%

OPEB

Active Platform: 59%
Passive Platform: 41%



HighMark Capital Management Strategy		Allocation* (%)
Capital Appreciation	(65-85% Equity)	6.14%
Balanced	(50-70% Equity)	27.63%
Moderate	(40-60% Equity)	39.91%
Mod. Conservative	(20-40% Equity)	14.91%
Conservative	(5-20% Equity)	1.75%
Other	(Custom)	9.65%
TOTAL		100.00%

* As of September 30, 2022; Based on allocations for agencies who have funded

Pension-Prefunding Sample Policies

1. Contribute 50% of a given year's realized year end surplus to address pension liability
2. Contribute full amount of annual PERS employer contributions, allowing anytime access to Trust assets
3. Contribute funds to stabilize PERS employer Miscellaneous and Safety rates through FY 23-24
4. "One equals five plan" → \$1M contribution for 5 years will save taxpayers \$5M over 25 years
5. 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
6. Maintain a 15% general fund reserve and target additional contributions over and above that threshold
7. Use ongoing savings from prepaying CalPERS unfunded liability vs. higher monthly payments
8. Use one-time revenue source & lower the minimum General Fund Reserve level (30% → 20%)

How to Start an OPEB Funding Strategy

It is important to create an OPEB Funding Policy to manage long-term costs

Funding options may include:

A. Put in full Actuarially Determined Contribution (ADC)

\$1,000,000

B. Put in full ADC, reimburse PAYGO at end of year

**\$1,000,000 -
\$300,000**

C. Put in difference between ADC and PAYGO costs

\$700,000

D. Put in lump sum amount and leave it to grow

\$5,000,000

E. Put in anything – something is better than nothing!

?

Long-Term Financial Plan

- GFOA recommends that all governments prepare and maintain a long-term financial plan that projects revenues, expenditures, and reserves for all major funds and government operations for at least 5 years into the future.
- A long-term financial plan should incorporate a pension & OPEB paydown strategy that is tailored to the agency's financial and policy considerations (availability of resources, competing priorities for funding, etc.)



Market Volatility

- Agencies should incorporate risk mitigation strategies within their long-term funding plan to address market volatility.
 - **Dollar Cost Averaging** - When an agency decides to make large lump-sum contributions to the plan to pay down an unfunded liability, the entire contribution is exposed to market risk prevailing at the time the contribution is made, whereas consistent contributions minimize the risk from market fluctuations.
 - **Diversification** - Pension and OPEB trusts are designed to mitigate against investment return volatility through diversification where assets are managed in a customized investment strategy that balances risk and return.



Assumptions



Realistic growth assumptions based on historical revenue trends and adjusted for extraneous factors and anticipated changes due to economic conditions.



Operating cost assumptions based on projected amounts adjusted for inflation, increases in personnel costs based on current MOUs, etc. Forecast should also include anticipated capital project needs, debt service expenditures, and other anticipated cash outlays.



Model alternate scenarios to evaluate potential threats to fiscal stability, such as revenue shortfalls resulting from an economic downturn. Determine whether reserves are sufficiently funded to ensure that services can be maintained during an economic downturn.

Fountain Valley Case Study

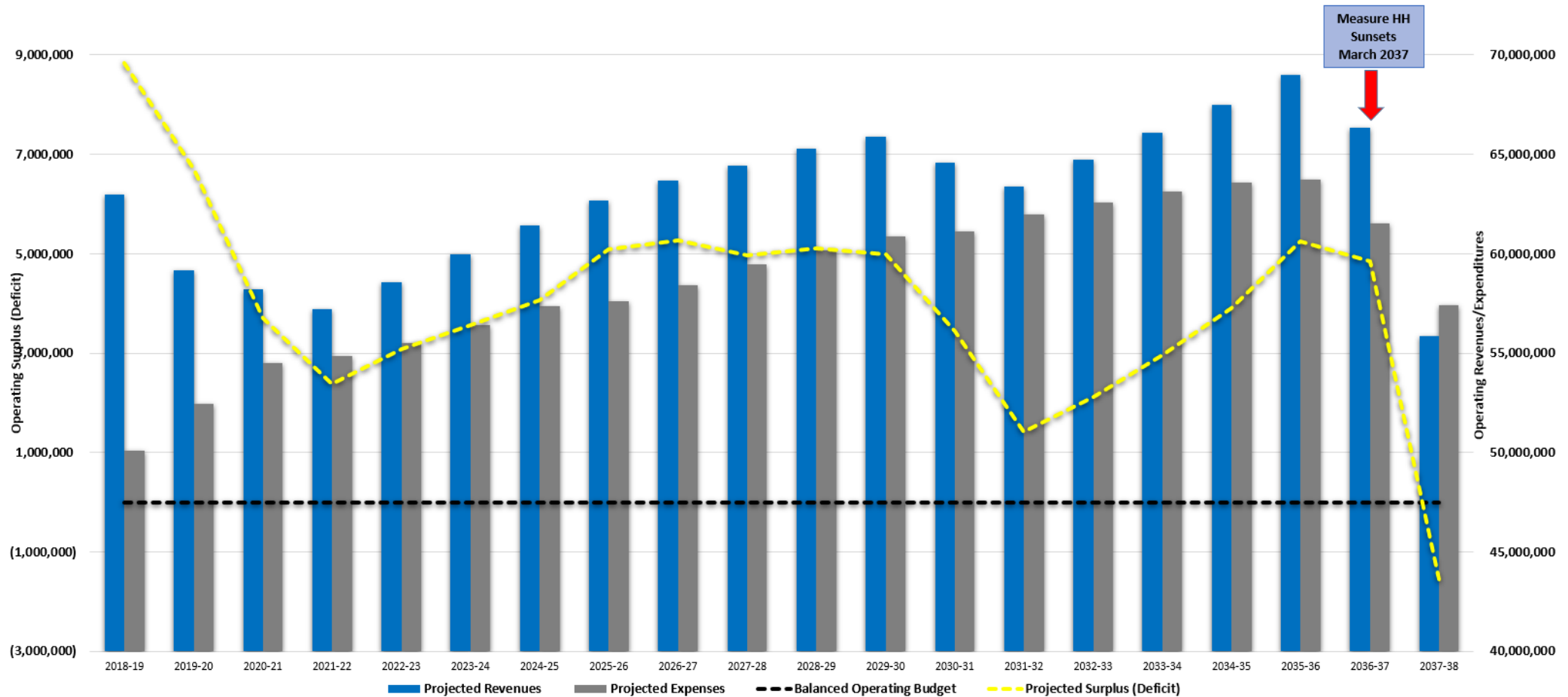


- Full-Service City: Miscellaneous and Safety
- \$66M Net Pension Liability (81% funded) at 6/30/21
 - Required Unfunded Accrued Liability (UAL) payment is \$7M per year
- \$32M Net OPEB Liability (27% funded) at 6/30/21
- In November 2016, the residents approved Measure HH, a one-percent (1%) Transactions and Use Tax, to cover an operating shortfall that could not be eliminated without impacting services.
- Fiscal policy is guided by a 20-Year Financial Plan, which encompasses the long-term operating and capital needs of the City.
- The long-term goal is to achieve fiscal sustainability with a balanced operating budget when the Transactions and Use Tax sunsets in 2037, and to eliminate the City's net pension and OPEB liability, and all other long-term debt.

Fountain Valley Funding Strategy

- Additional Discretionary Payments of \$2 million per year are projected to be made to CalPERS through 2037, which is in addition to the amounts required annually by CalPERS.
- The City also utilized a Section 115 Pension and OPEB Trust to provide for diversification, and to function as a stabilization fund.
 - The long-term targeted Pension Trust Reserve Level was \$24 million, which was based on the magnitude of exposure associated with long-term CalPERS investment returns falling short of the expected rate of return.
 - The long-term targeted OPEB Trust Reserve Level was based on the goal to fully fund the OPEB Trust by 2037.

20-Year Forecast (FV)



Tustin Case Study

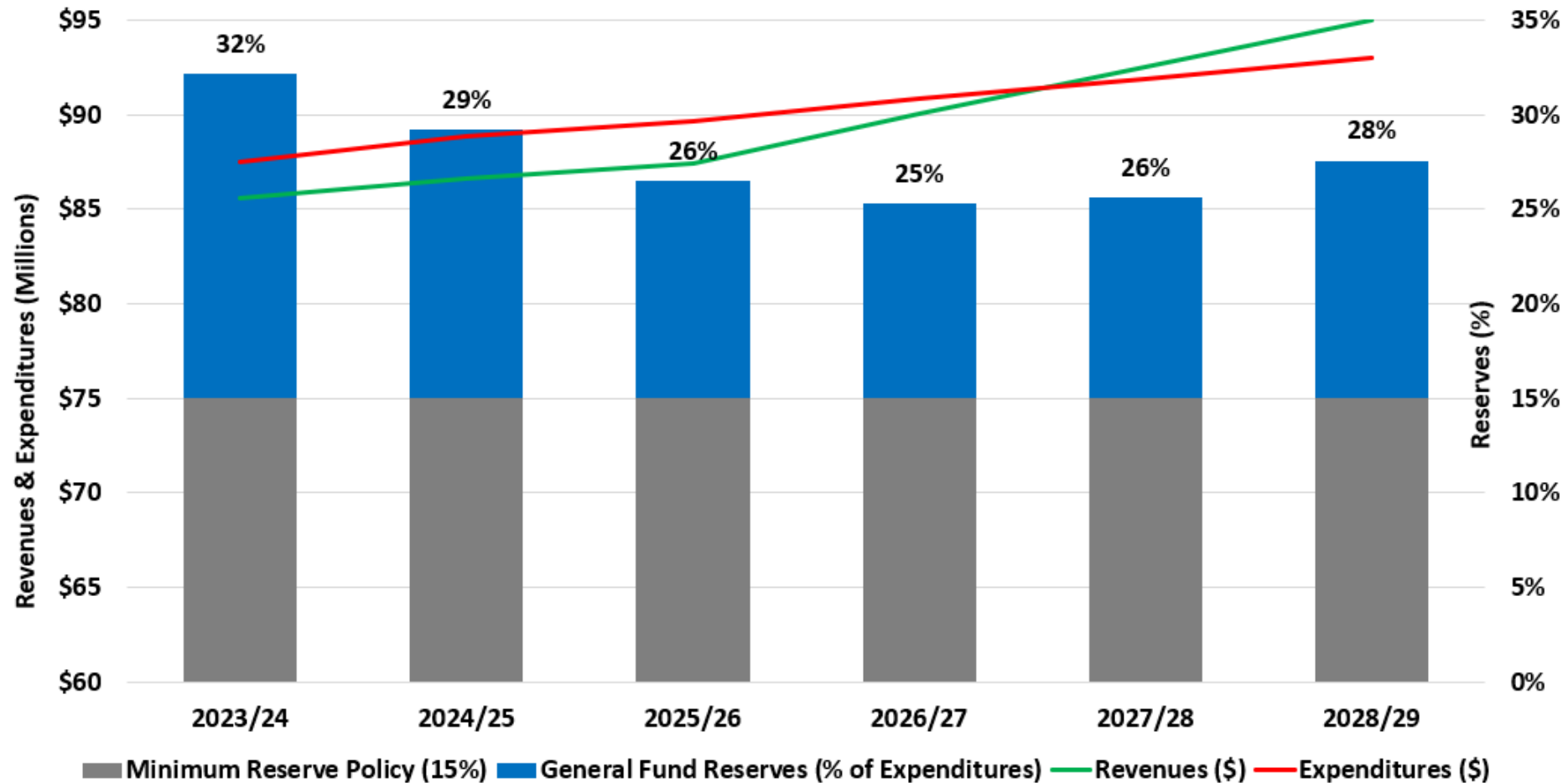


- Full-Service City: Miscellaneous and Safety
- \$50M Net Pension Liability (87% funded) at 6/30/21
- Required Unfunded Accrued Liability (UAL) payment is \$6M per year
- \$12M Net OPEB Liability (18% funded) at 6/30/21
- 7-Year Forecast shows a General Fund operating shortfall for the next 5 years. However, General Fund Reserves and ARPA (\$12M) provide the necessary resources to maintain services while the City works towards balancing its operating budget.
- In 2002, over 1,100 acres of land associated with a former military base was allocated to the City at no cost for economic development purposes. However, most of the land is undeveloped and requires significant investment in infrastructure (roads, sidewalks, utilities, parks, bridges, etc.)
- In September 2021, the City received \$69M from the sale of 25 acres of land located at the former military installation, which will be used for the development of 400 homes.
- The proceeds from the sale of land could be used to eliminate the City's net pension liability. However, if the City sent \$50M to CalPERS at the high end of a bull market, we risk losing some of the benefit of those dollars should the market fall.

Tustin Funding Strategy

- In 2018, the City Council established a goal to pay off the pension liability in 15 years, which utilizes a portion of land proceeds to fund an accelerated pension paydown plan.
- Since 2018, the City has made Additional Discretionary Payments to CalPERS, and has also utilized a Section 115 Pension and OPEB Trust to provide for diversification and to function as a stabilization fund. The pension paydown policy is reviewed each year in conjunction with the City's budget process.
- The current pension funding strategy calls for \$2M in Additional Discretionary Payments per year, and \$2M in Pension Trust contributions per year, which would allow the City to payoff all pension debt by 2030.
- Contributions to the City's OPEB Trust is based on the Actuarially Determined Contribution, which equates to approximately \$500,000 per year.

7-Year Forecast (Tustin)



Questions?

Thank you for Attending!

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