June 5, 2019

TO: Kevin Woodhouse, City Manager

From: Lorenzo Hines Jr., Assistant City Manager

SUBJECT: **Long Term Pension Mitigation Strategies**

The 2019-20 Proposed Budget contains a proposal to transfer of $200,000 from the General Fund balance to a Section 115 Trust to begin to mitigate the City's increasing pension costs. Local governments can fund essential governmental functions (i.e., retiree healthcare, pension) by the use of Section 115 Trusts. The Trust is irrevocable and designed to pre-fund retirement plan obligations. The assets of the trust are considered 'Fiduciary Funds". Fiduciary funds are legally set-aside assets that are available for use to reduce a city's Net Pension Liability Once contributions are placed into trust, assets from the trust can only be used for retirement plan purposes:

a. Reimburse agency for Retirement System contributions
b. Transferred directly to the Retirement System
c. Pay retirement related expenditures (e.g., actuarial, audit, etc.)

As requested by Council in the November 26, 2018 Council meeting, and per the recommendation in the July 17, 2018, San Mateo County Grand Jury Report entitled "Soaring City Pension Costs" the discussion below summarizes other pension mitigation options available to address the City's long-term pension costs.

The first group of options provide alternatives to accelerating payments to reduce pension liability. These options include:

1. Regular supplemental payments to CalPERS (beyond those required by CalPERS) to accelerate the amortization of their Unfunded Liabilities.

2. Irregular supplemental payments to CalPERS (beyond those required by CalPERS), as when a City has a budget surplus or receives special non-recurring revenues.

3. Electing to apply shorter Amortization Periods (that is, less than 20 years) to their Unfunded Liabilities. This would result in an increase in the annual pension payments.

4. Seeking additional general fund revenues that can be applied directly to paying pension costs or that can offset general fund budget shortfalls that would otherwise occur.

Given the City's current fiscal circumstances (flat revenues and increasing expenses), the City does not have the financial flexibility to take advantage of these options without jeopardizing a loss of City services or the current General fund balance. If, however, additional revenues materialize in the future, additional pension contributions could be considered as an option for the use of those funds.

5. Issuing pension obligation bonds

The following information is taken from an Advisory issued by the Government Finance Officers Association (GFOA) GFOA regarding Pension Obligation Bonds.

Pension obligation bonds (POBs) are taxable bonds that state and local governments have issued as part of an overall strategy to fund the unfunded portion of their pension liabilities by creating debt. The use of POBs rests on the assumption that the bond proceeds, when invested with pension assets in higher-yielding asset classes, will be able to achieve a rate of return that is greater than the interest rate owed over the term of the bonds.

However, POBs involve considerable investment risk, making this goal very speculative. Failing to achieve the targeted rate of return burdens the issuer with both the debt service requirements of the taxable bonds and the unfunded pension liabilities that remain unmet because the investment portfolio did not perform as anticipated.

In recent years, local jurisdictions across the country have faced increased financial stress as a result of their reliance on POBs, demonstrating the significant risks associated with these instruments for both small and large governments

Due to the speculative nature of POBs GFOA recommends that state and local governments do not issue POBs. (Please see the attached Advisory from GFOA for more information).

6. Establishing substantial reserves that can be applied in the future to help meet rising pension costs and/or accelerate amortization of Unfunded Liabilities.

The 2018-19 Adopted Budget expanded the City's Reserves Policy to address additional reserve designations, and begin funding them. The policy established the Fund Balance Commitments to the following categories:

i. General Fund - Fund Balance Commitment
ii. Compensated Absences Fund Balance Commitment
iii. Facility Maintenance and Replacement Fund Balance Commitment

The funds by their very nature could be used to mitigate any financial need driven by increasing pension cost, as there are the City's hedge against any economic uncertainty.

7. Reductions in general fund operating costs other than pensions.

The City's budget is structured to maintain a balance between the fiscal support for City services and the payment of debt services including pension debt. Reductions in GF operating costs would inevitably affect the quality and quantity of City services provided to Pacifica citizens in favor of addressing long-term pension costs. The City budget as currently structured addresses both needs.

8. Keeping employee salary increases at or below the levels assumed by CalPERS.

9. Negotiating cost-sharing agreements with employees under which employees pay a portion of the City's pension costs (without at the same time agreeing to offsetting

compensation increases). The City's current labor contract contain a cost sharing covenants.

10. Maintaining growth in employee salaries and COLAs at or below the assumed CalPERS rates.

11. To the extent allowed by law, consider the recommendation of the League of California Cities to renegotiate employee contracts to bring the pension Benefits of Classic Members in line with PEPRA Members, for future work. In particular, ensure that the salary used to determine final retirement compensation is based on the average of the final 3 years of employment (rather than highest 1 year), and that the salary is not enhanced by "spiking," such as by including overtime, unused vacation or sick leave, purchases of "air time,' and the like.

The preceding four options are directly related to the City's labor policies of maintaining salaries and benefits in a manner that is competitive within the local labor market yet remaining affordable given the City fiscal circumstances. In addition, the City's current contracts with labor units contain pension cost-sharing agreements