CITY OF MORRO BAY
CITY COUNCIL
AGENDA

The City of Morro Bay provides essential public services and infrastructure to maintain a safe, clean and healthy place for residents and visitors to live, work and play.

Special Meeting – Tuesday, August 13, 2019
Veterans Memorial Hall – 3:30 P.M.
209 Surf St., Morro Bay, CA

ESTABLISH QUORUM AND CALL TO ORDER

PUBLIC COMMENT FOR ITEMS ON THE AGENDA

SPECIAL MEETING AGENDA ITEM:

I. <u>STUDY SESSION</u>

OPTIONS TO ADDRESS UNFUNDED LIABILITIES; (CITY MANAGER/FINANCE)

RECOMMENDATION: Council receive staff presentation and provide direction, as necessary.

ADJOURN

DATED: August 9, 2019

____
John Headding, Mayor

THIS AGENDA IS SUBJECT TO AMENDMENT UP TO 24 HOURS PRIOR TO THE DATE AND TIME SET FOR THE MEETING. PLEASE REFER TO THE AGENDA POSTED AT CITY HALL FOR ANY REVISIONS OR CALL THE CLERK'S OFFICE AT 772-6205 FOR FURTHER INFORMATION.

IN COMPLIANCE WITH THE AMERICANS WITH DISABILITIES ACT, IF YOU NEED SPECIAL ASSISTANCE TO PARTICIPATE IN A CITY MEETING, PLEASE CONTACT THE CITY CLERK'S OFFICE AT LEAST 24 HOURS PRIOR TO THE MEETING TO INSURE REASONABLE ARRANGEMENTS CAN BE MADE TO PROVIDE ACCESSIBILITY TO THE MEETING.

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AGENDA NO: I

MEETING DATE: August 13, 2019

Staff Report

TO: **Honorable Mayor and City Council** **DATE: August 9, 2019**

FROM: **Scott Collins, City Manager**
Jennifer Callaway, Finance Director

SUBJECT: **Options to Address Unfunded Liabilities**

RECOMMENDATION

City Council receive staff presentation and provide direction, as necessary.

BACKGROUND

New accounting standards have dramatically impacted local government financial statements by requiring the net pension/Other Post-employment Benefits liability (OPEB effective date is FY 2017/18) be reported as a liability on the City's statement of Net Position; thereby reducing the City's financial net position (assets in excess of liabilities). Prior to the change in accounting standards in the long-term liability amounts referred to as unfunded accrued actuarial liability were not included on the City's balance sheet. Annual payments for pension and OPEB costs were paid on a "pay-as-you-go" basis, therefore no additional accrued actuarial expenses were added to City pension or health care costs and there was not an additional liability reported on the balance sheet. The addition of these unfunded long-term liabilities to the entity-wide financial statements has brought these liabilities to the forefront of attention among public officials and citizens nationwide.

In May 2018 with development of the FY 2018/19 Budget, Council conducted a budget study session focused options to address unfunded liabilities. At that time, Council was interested in early paydown of the City's unfunded liabilities should funding come available to do so. Early paydown reduces interest paid on the liability effectively saving the City money.

With adoption of the FY 2019/20 budget and City Council goals and objectives, financial and economic sustainability remains the primary goal of the City. As such, the Council has funded a collaborative economic development program with the Chamber of Commerce to support and grow existing businesses and encourage new business and development within key opportunity sites in Morro Bay. In addition, the Council has engaged in discussions to explore new revenue options, including an additive sales tax measure and/or Harbor Assessment District.

As part of the City's goal of financial sustainability, a discussion of the City' unfunded liabilities, specifically surrounding CalPERS has been requested to revisit options available to the Council to reduce overall obligations. The assumption of pay off options includes a variety of factors and amortization bases. These options presented below are "level percent" estimates (actuaries recommended method), however with further Council direction on which option staff should pursue,

Prepared By: ___JC_____	**Dept Review:** ______
City Manager Review: __SC______	**City Attorney Review:** _JWP_____

refined cost savings estimates can be provided.

DISCUSSION

City Plans

City of Morro Bay permanent employees participate in CalPERS. Sworn employees (fire, police and harbor patrol) are covered under the Fire and Police Safety plans respectively, while all other employees are covered in the Miscellaneous plan, which is a separate plan. A pooled plan was required by California law for those agencies who had fewer than 100 active members, which was applicable to the City's plans. These assets and liabilities are pooled with all other pooled plans in the State with fewer than 100 active members to provide a large, risk sharing pool. This risk sharing dramatically reduces or eliminates large fluctuations in an employer's pension contribution rate caused by unexpected demographic events.

Depending on an employee's position and hire date, a City employee is included in one of the nine possible plans as follows:

Plan	Miscellaneous	Safety Fire	Safety Police
Classic Members	2.7% at Age 55	3% at Age 50	3% at Age 50
Tier 2	2% at 60 (Effective Dec 10, 2011)	3% at Age 55 (Effective Mar 19, 2011)	3% at Age 55 (Effective Sept 17, 2011)
PEPRA Plan	2% at Age 62 (Effective Jan 1, 2013)	2.7% at Age 57 (Effective Jan 1, 2013)	2.7% at Age 57 (Effective Jan 1, 2013)

The annual employer contributions are determined by actuarial valuation reports prepared by CalPERS for each of the City's plans. Due to the amount of data involved, the employer rates for FY 2019/20 are set forth in the June 30, 2017 actuarial valuation report.

Beginning January 2018, public agencies that have collectively bargained in good faith and have completed impasse procedures (including mediation and fact finding) will have the ability to unilaterally require classic members to pay up to 50% of the total normal cost of their pension benefits. However, the employee contribution rate may only be increased up to an 8% contribution rate for miscellaneous members and 12% contribution rate for safety members. The City and Morro Bay Peace Officers Association agreed to a cost sharing arrangement where Classic and Tier 2 members will have a contribution rate of 11%.

CalPERS Funding Review

The CalPERS retirement system is funded by three main categories: (1) CalPERS Investment Earnings; (2) Employer contribution rates; (3) Employee contributions to CalPERS.

CalPERS reports that over the past twenty years every average dollar spent on public employee pensions has been sourced from the following:

- 61 cents – CalPERS investment earnings
- 26 cents – Employer contributions to CalPERS
- 13 cents – Employee contributions to CalPERS

On March 8, 2017, CalPERS announced the following average returns on its investment portfolio:

- 7.8% over the past five years
- 4.6% over the past ten years
- 6.9% over the past twenty years

Per CalPERS, the average retiree pension is $30,500 per year. The benefit paid to a retiree varies depending upon the number of years they have worked for a CalPERS participating government agency, the employee's salary, and the government agency's retirement formula. The City is one of over 3,000 government employers who participate in the CalPERS retirement system.

CalPERS Pension Fund Stability Initiatives

Over the past few years CalPERS has taken steps to stabilize and improve the system's fiscal strength and lower future risk to the pension trust's sustainability. The expected rate of return on the pension fund's investments referred to as the "discount rate" was reduced from 7.75% to 7.5% effective FY 2014/15. In December 2016, CalPERS voted again to lower its discount rate in steps beginning in FY 2018/19 from 7.5% to 7.0%. Lowering the discount rate impacts local governments, because with lower returns expected over time, it will require contribution rates to increase to provide sufficient assets to pay benefits.

In November 2012, the Public Employees' Pension Reform Act (PEPRA) was signed into law by then Governor Brown providing that new employees hired after January 1, 2013 are required to contribute more to their pensions and must also work longer before they can retire and begin to receive the benefits promised by their employers. CalPERS announced that in the four years since PEPRA reforms were put in place that employers like the California State government have experienced cost savings of 1.2% of payroll for miscellaneous employees and 5.1% of payroll for safety employees.

Unfunded Liability Status

The City's current actuarial valuation reports (June 30, 2017) calculated unfunded liabilities referred to as the Unfunded Accrued Liability as shown below:

Plan	**Unfunded Accrued Liability**
Miscellaneous Pension Plan	$12,859,550
Safety Fire Pension Plan	$4,370,417
Safety Police Pension Plan	$6,253,830
Total Unfunded Accrued Liability	**$23,484,045**

Funded Status

The following table presents the funded status of the City's pension plans. This percentage represents the value of the assets in the City's trust at the end of the fiscal year compared against the projected benefit obligation.

Plan (Classic Plans Only)	Funded Percentage
Miscellaneous Pension Plan	71.5%
Safety Fire Pension Plan	70.5%
Safety Police Pension Plan	70.7%

In comparing the City's funded status for its plans, the average funding status for local government pension plans across the nation is approximately 72%. Best practices for pension plans advocate funded status goals of over 80% be maintained.

Definitions:

- Unfunded Accrued Liability (UAL) – the difference between the estimated cost to pay retirement obligations and the market value of assets currently set aside to fund them. It is the present value of future employer contributions for service that has already been earned and is in addition to future normal cost contributions for active members; which represents the City's debt or pension liability.
- Funded Ratio – An assessment of the need for future employer contributions based on the selected actuarial cost method used to fund the plan.

<u>Origins of the Pension Unfunded Liabilities</u>

Experts in the field, have highlighted in public presentations that because investment returns have provided 65% of the retirement funds paid out to retirees the primary reason for the development of the unfunded liabilities for local government pension plans has been due to lower than expected investment returns and not primarily due to enhanced benefits that may have been agreed to in past years through the collective bargaining process. According to information released by CalPERS, the City's pension unfunded liabilities developed because of two major market downturns since 1995. The first being the downturn in the early 2000's related to the "dot com" stock market bubble and the second major loss related to the global economic "Great Recession" of 2008.

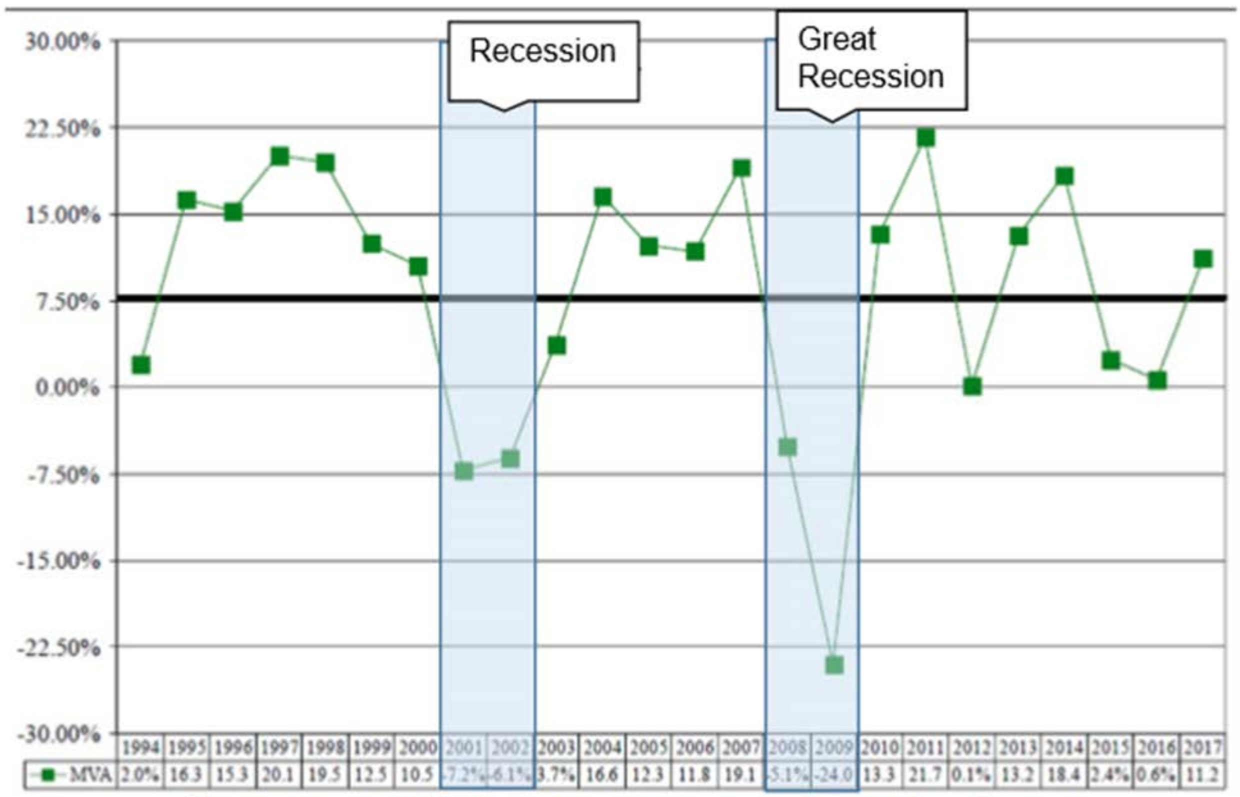
CalPERS Past Investment Performance and Rate of Return Prior to 2017, CalPERS provided pension benefits based on a 7.5% annual long-term rate of return. This meant that CalPERS expected to earn approximately 7.5% on average each year on the contributions into CalPERS. However, in the last two recessions, CalPERS has suffered significant losses.

- During the recession in 2000 and 2001, CalPERS had losses of 7.2% and 6.1%, respectively, in investment earnings.
- During the Great Recession in 2008 and 2009, CalPERS suffered losses of 5.1% and 24.0%, respectively, of investment earnings and since then, has been struggling to recover those losses.

The following chart illustrates CalPERS historical investment performance at the end of each year, demonstrating the two significant losses.

CalPERS Historical Investment Returns 1994 –2017

Chart 1: CalPERS Historical Investment Returns 1994 –2017



Above assumes contributions, payments, etc. received evenly throughout year.

Another large impact was a series of “assumption changes” made by CalPERS actuaries that added millions of dollars to the City’s accrued pension liabilities. These assumption changes, such as increasing the expected life span of retirees, among other factors increased the expected payments made to retirees out of the trust.

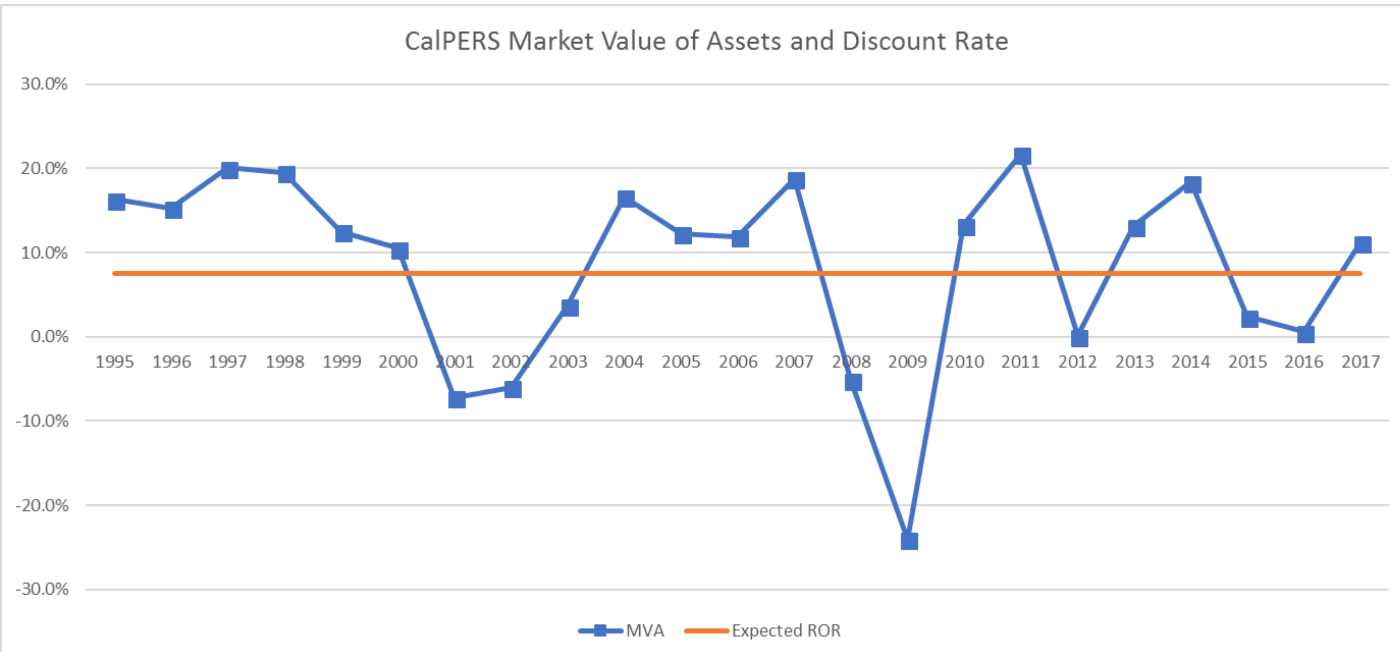
<u>City’s Proactive Steps Take to Date</u>
The City prudentially addressed a major new unfunded liability pertaining to a “side fund” liability created by CalPERS when state law required the City’s plans be placed in a state pool. Upon doing this, the City incurred a side fund liability determined by CalPERS for the City’s proportionate share of pooled unfunded liabilities. The City paid off the safety police side fund in FY 2017/18 and prepaid the safety fire side fund in FY 2017/18 as well saving approximately $10,000 in interest and reduced future costs.

In addition, the City has renegotiated retirement tiers, and negotiated increased employee contribution for one bargaining unit. Lastly, the City pays the annual contribution amount in one lump-sum payment in July, reducing overall interest charges throughout the year. In FY 2018/19 the annual lump sum payment saved the City approximately $63,000 and for FY 2019/20 the annual lump sum payment saved the City approximately $71,000.

<u>Investment Return History</u>
One of the most critical assumptions in attaining full funding goals for the CalPERS pension plan is the rate of return on investments in the trusts. CalPERS’ current annual rate of return (ROR) assumption is 7.5%. Assuming this rate of return is attained, then funding of the pension obligations

would be derived 65% from investment gains and 35% from contributions. If the 7.5% rate of return is not realized, then contributions from employers and employees will have to increase. Unfortunately, this ROR has not regularly been achieved by CalPERS (11.2% in 2017, 0.6% in 2016 and 2.4% in 2015) and the outlook from the investment community and actuaries for a 7.5% annual rate of return for the near future is increasingly pessimistic. In fact, the average actual rates of CalPERS returns in the table below have fallen below expectations in several time periods.

The CalPERS investment returns over a twenty-year time period are presented below compared against the assumed 7.5% discount rate which is presented by the solid blue line on the graph.



<u>Future Pension Employer Cost Forecast</u>
As previously stated, in December 2016 the CalPERS Board announced a plan to lower its discount rate from 7.5% to 7.0%. Effective with FY 2018/19 the phase-in of the discount rate change approved by the Board is as follows:

Valuation Date	Fiscal Year for Required Contribution	Discount Rate
June 30, 2016	FY 2018/19	7.375%
June 30, 2017	FY 2019/20	7.25%
June 30, 2018	FY 2020/21	7.00%

The immediate effect of this change is the actuarial valuation report being prepared for June 30, 2016 by CalPERS which sets the employer contribution rate for FY 2018/19 at lower discount rate of 7.375%. This action will lead to increased actuarial accrued liabilities because with lower expected returns there are lower projected assets to meet the expected pension obligations.

Speculations are being raised about future actions the CalPERS board may take including potentially reducing its discount rate below the 7% rate target approved by the board in December 2016. More recently CalPERS has indicated that they are not currently planning to reduce the discount rate below the 7% target already approved. The CalPERS Board has adopted a Risk Mitigation policy that will be effective in 2020 once the effect of the change of the discount rate to local governments has been phased in by CalPERS. This policy will take advantage of years when returns exceed 2% above the forecasted returns for the CalPERS investments. In those years, CalPERS will make gradual cuts of 0.05% to 0.25% lowering the discount rate over an expected 20-year phase to a new target of 6.0%. This strategy would allow CalPERS expected returns to align better with CalPERS actual returns for the next thirty years (according to Wilshire Advisors – 6.2% over the next decade and 7.8% in following two decades). The Risk Mitigation Strategy also takes advantage of return years above forecasts by shifting investments into less risky (less volatile) investment instruments/categories over the same timeframe.

Other Postemployment Benefit Plans (OPEB)

Contribution
The City's primary OPEB cost obligation is for retiree health benefits under its election to participate in the CalPERS Health Benefit program. Due to CalPERS purchasing power, the City has experienced competitive health care rates; however, as a condition of joining the CalPERS health program, the City agreed to contribute the minimum amount required by law per month towards retiree health care coverage._ While some agencies negotiated additional contributions to retiree health through collective bargaining, Morro Bay's contribution for retiree health benefits is the minimum employer contribution amount allowed by CalPERS, which is currently $139 per month, with the retiree paying the remaining cost of their health plan at the same rate offered to active employees. .

Net OPEB Liability
The City's net OPEB liability was measured as of June 30, 2018, and the total OPEB liability used to calculate the net OPEB liability was determined by an actuarial valuation as of June 30, 2018.

Discount Rate
The discount rate used to measure the total OPEB liability was 3.8 percent. The projection of cash flows used to determine the discount rate assumed that City contributions will be made at rates equal to the actuarially determined contribution rates. Based on those assumptions, the OPEB plan's fiduciary net position was projected to be available to make all projected OPEB payments for current active and inactive employees. Therefore, the long-term expected rate of return on OPEB plan investments was applied to all periods of projected benefit payments to determine the total OPEB liability.

Change in the Net OPEB Liability:

	Increase (Decrease)		
	Total OPEB Liability (a)	Plan Fiduciary Net Position (b)	Net OPEB Liability/(Asset) (c) = (a) - (b)
Balance at June 30, 2017	$ 2,373,450	$ -	$ 2,373,450
Changes Recognized for the Measurement Period:			
Service Cost	112,255	-	112,255
Interest on the total OPEB liability	91,031	-	91,031
Changes of benefit terms	-	-	-
Difference between expected and actual experience	-	-	-
Changes of assumptions	-	-	-
Contributions from the employer	-	64,978	(64,978)
Net investment income	-	-	-
Administrative expenses	-	-	-
Benefit payments	(64,978)	(64,978)	-
Net Changes during July 1, 2016 to June 30, 2017	$ 138,308	$ -	$ 138,308
Balance at June 30, 2017 (Measurement Date)	$ 2,511,758	$ -	$ 2,511,758

Sensitivity of the net OPEB liability to changes in the discount rate
The following presents the net OPEB liability of the City, as well as what the City's net OPEB liability would be if it were calculated using a discount rate that is 1-percentage-point lower (2.8 percent) or 1-percentage-point-higher (4.8 percent) that the current discount rate:

Plan's Net OPEB Liability/(Asset)		
Discount Rate - 1% -2.80%	Current Discount Rate (3.80%)	Discount Rate + 1% -4.80%
$ 2,942,775	$ 2,511,758	$ 2,167,631

<u>Possible Strategies to Meet the Future Unfunded Pension Challenges</u>
Concluding that the unfunded liabilities arise chiefly out of investment returns that fail to meet CalPERS expectations or result from CalPERS changes in assumptions, it would appear that local government have limited opportunities to influence the balance of the unfunded liabilities as calculated by CalPERS. However, there are opportunities/choices available that the City can explore to address this issue including the following:

<u>Option 1: Status Quo</u>

The status quo option essentially entails that the City continues to pay down gradually the unfunded liability with the existing rates that CalPERS is charging the City. Under this option, the pay-off duration is estimated to be 29 years. The rates and payoff duration will fluctuate based on market conditions.

The City's current funding approach utilizes the status quo amortization scheduled referred to as the "Five-Year Ramp Up/Down-Direct Rate Smoothing" policy which provides the minimum City contribution required by CalPERS and includes a graduated payment increase to allow employers to absorb the change more smoothly. Unfortunately, this policy inevitably costs more in the long-run because the required annual payment does not cover the full interest accrual in the early years and any shortfall in payment of interest is added to the principal balance. Beginning in FY 2018/19 the City will prepay the unfunded amortization amount in one lump sum payment in July, saving approximately $50,000 in interest charged by CalPERS versus paying it monthly over the fiscal year.

<u>Option 2: Fresh Start</u>

The City's second option is to make a "fresh start." A fresh start is a CalPERS term for re-amortizing the current unfunded liability over a shorter period of time. There are two fresh start choices described below, one for a 20-year fresh start and the second for a 15-year fresh start. Staff notes that future actuarial valuations could create new "unfunded" liabilities that will not be addressed by the fresh start option.

Table 1 below summarizes the savings for a 20-year and 15-year fresh start options. These are provided as estimates only as the payments under a fresh start are expected to increase by a flat 3% each year and also vary depending on the plan that early payment is applied towards. The City could commit to a 20-year fresh start, amortizing the City's liability over a 20-year period. Under this scenario, the City's estimated FY 18/19 contribution would increase by approximately $259,251 and the City would save an estimated $1.8 million over the 20-year period (if applied towards the classic miscellaneous plan). Alternatively, the City could commit to a 15-year fresh start, amortizing the City's liability over a 15-year period. Under this scenario, the City's estimated FY 18/19 contribution would increase by approximately $479,324 and the City could save approximately $6.2 million over the 15-year period (if applied towards the miscellaneous plan).

Plan	20-Yr Amortization	15-Year Amortization
Misc	$ 1,847,250	$ 6,152,024
Police	$ 1,151,899	$ 3,132,800
Fire	$ 466,801	$ 1,862,475

Based on the City's financial projections at this time, an annual expenditure increase would likely need to be supported through utilization of the City's General Fund Emergency Reserve.

Fresh-start options for either the Police or Fire plan may be more attainable for the City. The average increase in payments over the amortization period are outlined in the chart below:

Average Increased Payment		
Plan	**20-Yr Amortization**	**15-Year Amortization**
Misc	$ 126,679	$ 262,935
Police	$ 53,796	$ 132,866
Fire	$ 49,626	$ 99,402

Staff is currently working with our assigned CalPERS staff (an actuary) to determine a fresh start or lump sum pay off towards the City's Tier 2 and PEPRA plans. The most recent actuarial evaluations will be available in September and will be the final phase in of the discount rate changes. Based on initial conversations a full payoff of the UAL's for the City's Tier 2 and PEPRA plans in January of 2020 would total $480,000. This would fully fund those plans and may be a more attainable option for the City at this time. Alternatively, the City could "fresh start" the Tier 2 and PEPRA plans over a 2 to five-year period for reduced annually payments. Staff will continue to work with our actuary once the final reports are available to fully quantify the savings the City could achieve if the City were to pay off the UAL or fresh start for the Tier 2 and PEPRA plans.

Option 3: Additional Lump Sum Contributions

Alternatively, the City could choose to make lump sum payments above the existing required contributions when resources are available to do so. This is described by CalPERS as Additional Discretionary Payments, and involves the City making additional payments either once annually or making additional discretionary payments above the amounts required by CalPERS on a monthly or a payroll cycle basis during the fiscal year. The advantage of the lump sum option is that the City can leave its payment obligation status quo but can opt to make annual payments when budget circumstances are favorable.

Option 4: Establish a General Fund Reserve to Fund a 20-Year Fresh Start with Additional Lump Sum Options

In discussions with CalPERS, staff confirmed that one option is to combine a fresh start with a lump-sum contribution. The lump sum payment would be recommended to be made from a newly established General Fund PERS Reserve. This option provides the benefit of savings that accumulate from a fresh start option because the amortization period will shorten from an average of 30 years to 20 years and the newly established General Fund PERS Reserve are expected to be available to help fund the higher initial annual payments required as a result of the 20-year fresh start.

It should be noted that the PERS unfunded liability is not a fixed principal balance and the liability changes from valuation period to valuation period. CalPERS completes a new "base year' valuation of the liability every two years and the liability can change due to market gains and losses, changes in benefits, and changes in actuarial assumptions.

A General Fund PERS Reserve account can be established from currently available General Fund Emergency Reserves and/or year-end savings. Establishing such a PERS reserve would require Council action.

Establishing a dedicated Reserve would enable the City to:

- Match required payment fluctuations based on change in actuarial assumptions and experience gains or losses.
- Provide funding sources for higher payments required under a fresh start program. This option can provide significant saving, paying off the unfunded liability in 20 years instead of 30 years. Based on the City's current financial projections, an annual expenditures increase associated with any fresh start option does not appear sustainable over the amortization periods of either 15 or 20 year options without dedicated reserve to fund the payment differences over time.

Three different funding scenarios using this option are summarized below.:

Option 5: IRS 115 Pension Trust

This option involves prefunding the pension unfunded obligations through an IRS approved independent retirement plan administrator such as those currently administer by Public Finance Manager (PFM), Keenan Associates, or Public Agency Retirement Services (PARS).

Option 6: Pension Obligation Bonds

Consider issuing taxable pension obligation bonds, the proceeds of which would be used to make additional discretionary payments to CalPERS reducing the unfunded liability but also increasing the level of City bonded debt.

Option 7: Employee Cost Sharing

With the passage of PEPRA, local governments are allowed to agree to cost share the employer required contributions with their employees.

Option 8: Line of Credit

This idea originates from a Southern California City forum on unfunded liabilities. Essentially, it involves using "one-time" balances as a funding source for additional discretionary payments for pension unfunded liability pay-downs. The City would match the withdrawal with a blank line of credit to borrow against should the need arise for the one-time funds. The current borrowing rate for the line of credit is likely to be less than the rate charged by CalPERS on the unfunded balance.

Analysis of Unfunded Liability Funding Strategies

Status Quo:

Pros

- Because of the somewhat arbitrary nature of CalPERS unfunded pension liability calculations, this option gives the "minimum" payment to the CalPERS pension trust.
- Preserves local control of cash assets for other discretionary City purposes beyond the amounts actuarially required to be paid to the Pension Trust.

Cons

- If rates of return continue at historic low levels, CalPERS will be adding to the unfunded lability an "asset loss" which is amortized up to 7% over approximately 20 years. Much like a home mortgage, the interest costs amortized over that period will be substantially higher than the original amount of the asset gain or loss.
- The unfunded liability is likely to grow to higher levels with corresponding increased amounts of required employer contributions needed to fully amortize them. This situation has the potential to adversely impact the City's future operating budgets.

Shorter Amortization Schedule – "Fresh Start"

Pros

- This option would shorten the current amortization from 30 years to 20 or 15 years. This option would require the City to commit to a higher annual employer pension payment level, much like a homeowner refinancing their home mortgage over a 15-yer period from a 30-year amortization period, whereby the loan would be paid off earlier but the monthly payments would increase from amounts paid for a 20 year mortgage.
- Should the City apply for a "fresh start" to a 20 or 15 years amortization period, the City could expect annual payments to increase from $50,000 to $263,000 per year respectively.
- Based on current data, the City could experience total interest savings of approximately $467,000 on a 20-year fresh start for the Fire classification and $6.2 million if the City chose a 15-year amortization period on the miscellaneous classification.

Cons

- If the City were to establish an alternative amortization schedule, the annual average annual budgeted pension employer contribution is estimated to increase by $116,000 to $250,000 based upon the 2016 Actuarial Valuation reports. This action would likely require a corresponding reduction in City funds dedicated to support operating budget service levels to accommodate this increase in pension expense for each future fiscal year affected.
- The fresh start program is not flexible. Once the City commits to the new amortization, it cannot change to a longer period to reduce costs and balance its budget. There may be one possible way to lengthen it again, but it would require the City to declare itself in a fiscal emergency.

Lump Sum "One-Time" Voluntary Payments

Pros

- This option includes many different varieties of different payment options. The City could elect to make an additional annual or monthly payment, or intentionally pay a higher amount per covered payroll with the excess payment applied to the unfunded balance.
- The City's additional payments are discretionary as to time and amount of payment, providing flexibility if future circumstances allow for higher, lower or perhaps no payments for that particular fiscal year.
- Interest savings are dependent upon the amount of additional payment but based on the current staff estimates a "one-time" payment would yield the following interest savings over the amortization period estimates:
- Function very much like a homeowner making additional mortgage principal payments, this strategy provides flexibility and fi the City commits to a funding strategy with regular pay-downs, the unfunded liability could be retired ahead of the scheduled amortization period by a number of years.

Cons

- CalPERS has advised that additional discretionary payments can only be applied against outstanding unfunded liabilities. For instance, if the City were to elect to pay off the unfunded liability in its entirety and the returns over time exceeded CalPERS estimates, CalPERS would not return or credit the City's plan for the excess amounts paid into the trust.
- CalPERS has advised staff that once monies are paid into the pension trust, they are never returned back to the City. Future assets in excess of liabilities should they occur will not be refunded back to the City.
- Volatility of annual returns is a major concern for lump sum payments. Because of the aggressive nature of the CalPERS investment program, amounts paid into the pension trust are subject to large scale downturns in the stock market. For instance, had the City made a large lump sum payment to CalPERS prior to the stock market crash of 2008, the amount paid in would have incurred an approximate 30% "haircut" with only 70% of the amount paid in being available to apply against the unfunded liability.
- Future City Councils may not view the discretionary payments as a priority and the fiscal disciple to make these payments may decline as service level demands on the operating budget increase in future budgets.

Section 115 Trust (Pension Plan)

Pros

- This option would establish an Internal Revenue Service (IRS) sanctioned trust to accumulate assets to pre-fund the unfunded liabilities. The City would make periodic payments to the trust over time, building an asset portfolio that is irrevocably dedicated to funding pension obligations.

- The trust can be set up with alternative investment objectives from the aggressive approach used by CalPERS which could serve as a hedge against the volatility of placing all the City's available funds into the CalPERS pension trust.
- The City retains local control of the trust. If a future budget year has fiscal difficulties, the City could draw monies out of this trust (recommended as a "one-time" draw) to pay for other expenditure categories.
- Monies could be transferred out of this trust at any time with Council approval to fund additional discretionary payments to pay down CalPERS unfunded liability.

<u>Cons</u>

- Monies placed into the trust are irrevocable under IRS rules. The funds must be used only for employer pension contributions. They cannot be withdrawn and used for another governmental purpose in the future unless the unfunded liability was fully paid, and no liability existed for which the funds were placed into trust.
- At this time, staff believes the amounts placed in the trust would not be allowed to be factored into the Net Pension Liability under current Government Accounting Standard Board (GASB) guidance. Staff understands that GASB is reviewing its position and may allow it to be a direct offset against the calculated Net Pension Liability amount disclosed in the City's CAFR.

<u>General Fund Reserve for Pension</u>

<u>Pros</u>

- Funds in this reserve would be available for use as a funding source for any of the strategies approved by the City Council including additional discretionary payments.
- Funds held in the reserve generate interest earnings that could be used for the City's General Fund operating budget.

<u>Cons</u>

- Though held as a committed reserve, a future Council could re-direct these reserve funds to another governmental purpose by resolution.
- Funds held in reserve are not considered irrevocable and cannot be used as a direct offset to reduce net pension liability on the City's financial statements.

<u>Pension Obligation Bonds (POB's)</u>

<u>Pros</u>

- Pension Obligation Bonds are taxable bonds (meaning they carry a higher interest rate than tax-exempt bonds) issued by the local government. The proceeds could then be used to pay down the unfunded liability.
- In the best-case scenario, over the long term the interest cost of borrowing to the City would be lower than the total returns made in the pension trust.

<u>Cons</u>

- The proceeds of the bonds paid into the trust may fail to earn more than the taxable interest rate owed over the term of the bonds, causing the actual pension shortfall in terms of debt to increase.
- Pension Obligation Bonds are complex instruments that carry considerable risk.
- Issuing taxable debt to fund pension liabilities would increase the City's level of bonded debt burden, limiting potential uses of debt capacity for other purposes and possibly lowering the City's credit rating.
- In January 2015 the Government Finance Officers Association (GFOA) issued a Best

Practices/Advisory recommending that state and local governments do no issue pension obligation bonds. GFOA commented, "the use of POB's 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 s great than the interest rate owed over the term of the bonds. However, POB's 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 liabilities that remain unmet because the investment portfolio did not perform as anticipated."

Employee Cost Sharing

Pros

- With the passage of PEPRA, the City's employees are permitted to agree to cost share the employer's pension contributions.
- The City would experience annual expenditure savings that could be directed to additional discretionary payments to pay down the unfunded liability.

Cons

- Cost sharing would require bargaining with the City employees through the collective bargaining process and is speculative as to whether or not an agreement could be reached between the City and its employees. The City negotiated a cost sharing arrangement with the Morro Bay Peace Officers Association and has committed agreements with SEIU and the Firefighters Association through June 30, 2020.

Bank Line of Credit

Pros

- This strategy essentially involves using monies set aside for contingencies such as the City's General Fund Emergency Reserves to pay down the unfunded liability. At the same time the City would secure a bank "line of credit" for similar amount that could be advanced by the bank at the time it would be needed, should a catastrophic or emergency event arise.
- No interest debt would be paid until the bank advances funds, so cost of borrowing other than annual costs charged by the bank to maintain the line of credit.

Cons

- The line of credit could be viewed by credit analysts as additional debt limiting new debt capacity in the future.
- There is an annual financing expense that would be incurred regardless of whether funds were advanced from the bank.

CONCLUSION

Staff has provided a variety of options to consider in addressing the unfunded pension liability. In helping to guide council direction, staff recommends that the following principles be kept in mind and considered in providing direction to staff:

Volatility: Experts in the field have advised local government councils in many cities that an important goal is managing the risk of the unfunded liability is to manage the volatility of the returns on the assets in the CalPERS pension trust.

Diversification of Risk: Volatility can be mitigated by diversifying the risk amongst various strategies and liabilities so that were an adverse event like a major stock market correction to occur, such an event's negative consequences to the unfunded liability would be lessened.

Local Control of Assets is Important: More local control of assets is preferable to less local control over the custody and risk tolerance of the invested assets.

Based upon these principles, staff recommends that Council not consider the issuance of Pension Obligation Bonds or the Bank Line of Credit. Similarly, staff recommends that the Council not consider the Fresh Start option as described.

Staff recommends that the Council direct further analysis and determination of funding options for full payment or fresh start of the Tier 2 and PEPRA plans, targeting payment in January 2020 when Fiscal Year 19/20 year-end results are known and savings can be quantified.

ATTACHMENTS

1. City Managers Department Pension Sustainability Working Group White Paper – Jan 2019

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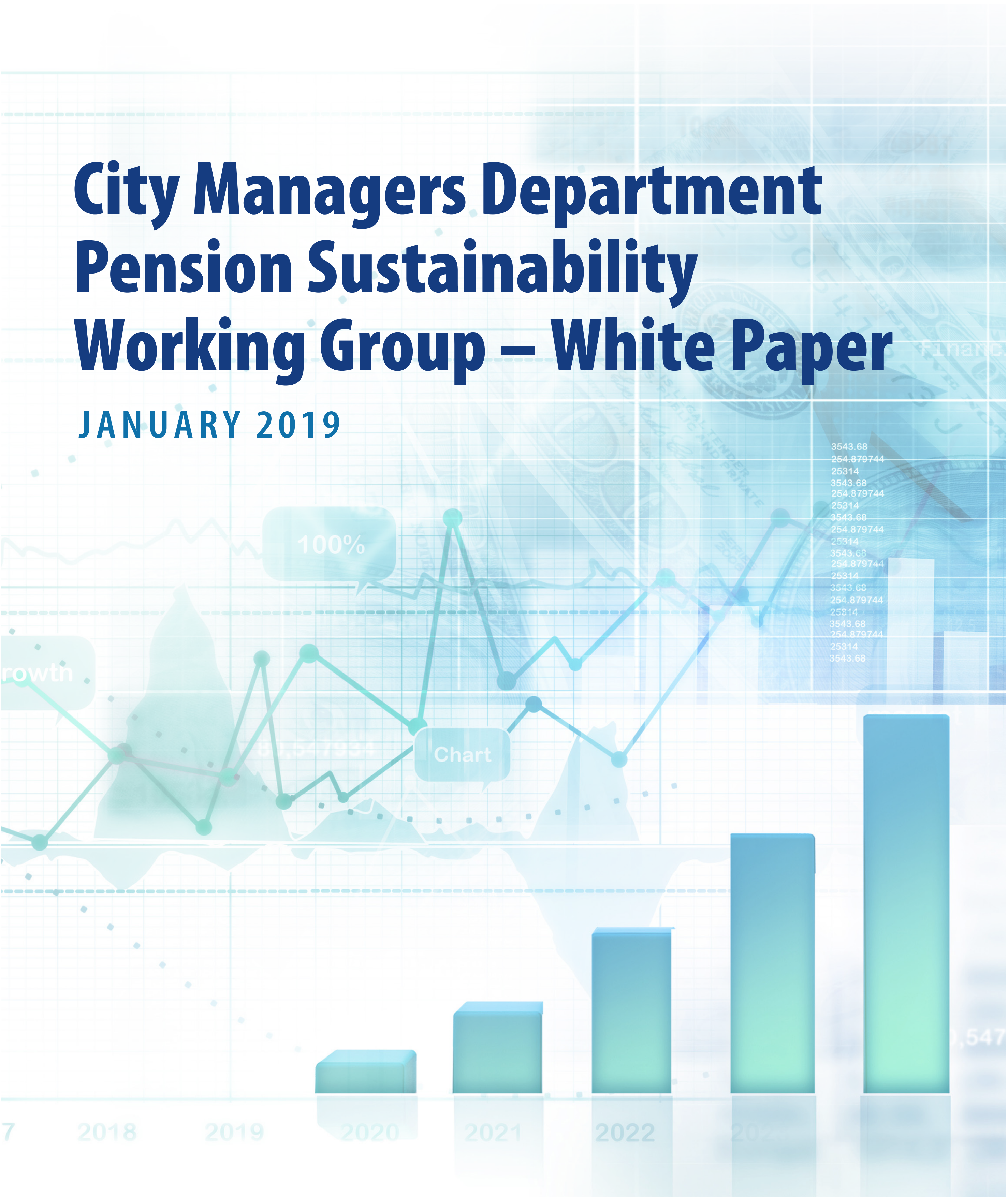
City Managers Department Pension Sustainability Working Group – White Paper

JANUARY 2019



CITY MANAGERS DEPARTMENT

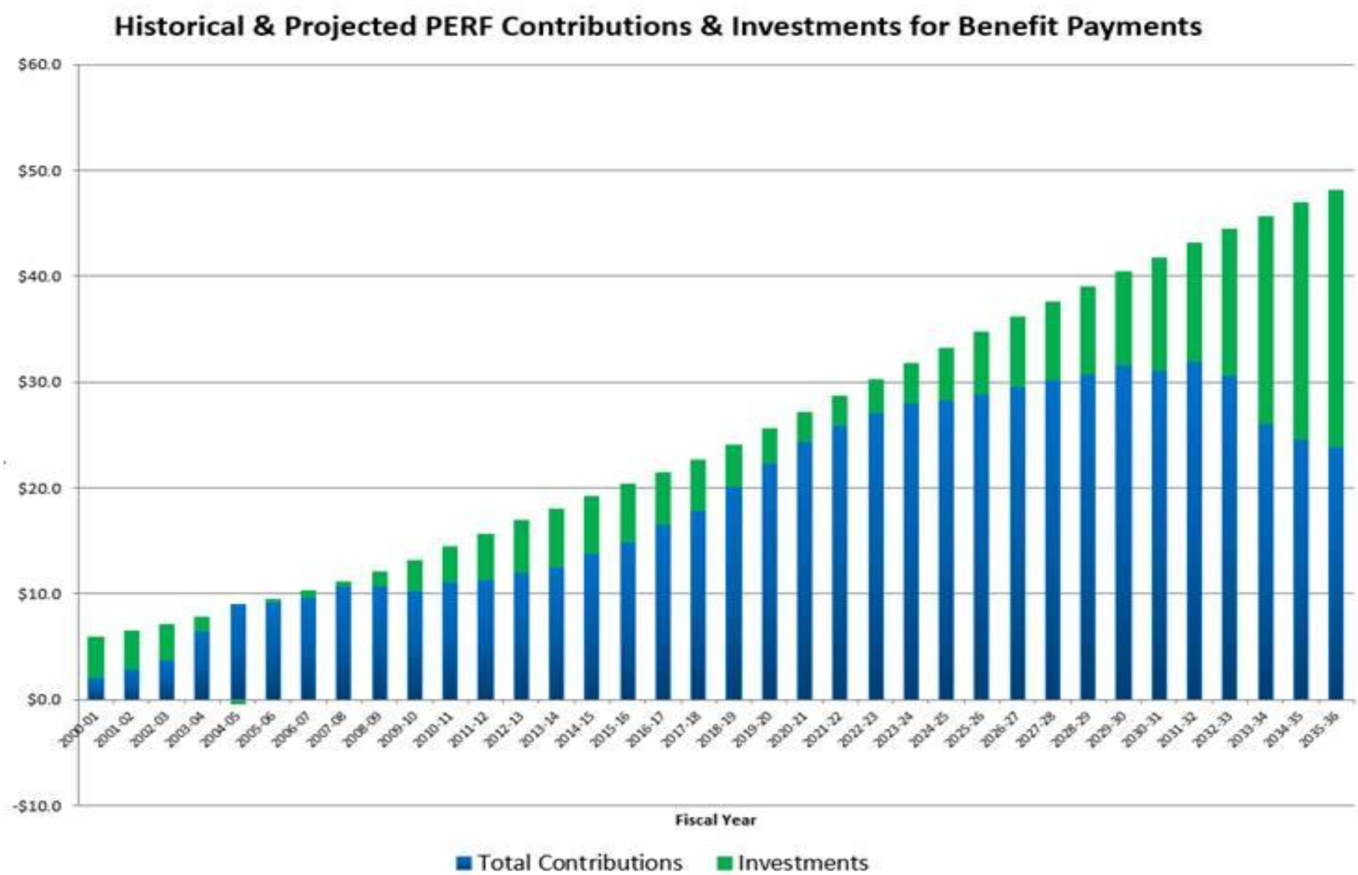
PENSION SUSTAINABILITY WORKING GROUP – WHITE PAPER

This whitepaper is the product of the Pension Stability Working Group, which consists of city officials from across the state (City Managers, Finance Directors, Human Resource Directors, and Elected Officials.) These individuals convened, under the umbrella of the City Managers professional department, to drive awareness and inform fellow local government officials of the fiscal challenges that cities will face as a direct result of increasing pension obligations as well as educate them on the overall sustainability of local pension structures.

It is important to note that this document and its contents have not been approved or endorsed by the League of California Cities' governing bodies or Board of Directors. The recommendations put forth in this document shall not be construed, as the policy proposals, preferences, recommendations, or direction of the League of California Cities on this matter.

Executive Summary

Over the past decade pension expenses have increased substantively for municipal governments across the nation. As CalPERS continues to implement its strategic goal of improving the long-term sustainability of the system, all actions to further reduce risk have resulted in increased costs to most member agencies.



As shown by the chart above provided by CalPERS the peak of these contributions is projected to happen over the next 10 -12 years.

The reality is that pension cost increases of this magnitude are unsustainable despite the post-recession economic recovery and many cities across California cannot absorb the increased costs of providing retirement benefits. As such, without intervention, the cost of pension benefits will reduce capacity to pay for programs and services. It is within this context that the League of California Cities City Manager's Department initiated this white paper, to outline options and opportunities to balance the reality of rising pension costs with the organizational mandate to deliver programs and services to the communities they serve.

With regard to public pensions, we find as follows:

1. We must recognize the importance and value of attracting and retaining high-performing public employees to design and deliver vital public services to local communities.
2. We must recognize and support the value of a reasonable, dependable, and financially sustainable, employer-employee funded Defined Benefit (DB) plans for career employees; supplemented with other retirement savings options including personal savings (e.g. 457 Plan or 401a Defined Contribution Plan (DCP)).
3. Employees should incur/pay at least half of their Public Pension "Normal Costs" and be allowed to negotiate a cost-sharing of the full ARC as well.
4. Employee pensions should be portable across all public agencies to sustain a competent cadre of California public servants.

The following summarize the recommendations included in the white paper:

1. Develop a strategy for how to revise the application of COLA's to retiree benefits.
2. If the Courts do not rule in a manner that enables us to rectify the existing problems, the League should initiate a dialogue with its membership regarding the cost/benefit and strength of support for the League sponsoring a statewide initiative to change the pension system.
3. Continue lobbying strategy primarily directed at the CalPERS Board, pushing for changes in their current investment strategy.
4. Re-consider converting currently deemed "Classic" employees to the same benefit formula now in place for PEPRA employees, <u>for future years of service.</u>

INTRODUCTION

The Great Recession has forever altered and indelibly marked the current financial condition of the California Public Employees Retirement System (CalPERS). The same can arguably be said of all other similarly managed, Defined Benefit Retirement Systems for public employees across this State and the Nation. The concerns and challenges facing these retirement systems are well-documented and the calls for action are registered regularly in the media. Strong concerns also exist among those of us that are charged with managing public agency budgets and employee expectations of a fair and secure retirement. The time to act is now as delays only serve to compound the problems.

Indeed, significant statewide pension reforms have been implemented since the financial collapse of 2008/09 wherein CalPERS saw a negative 27 percent return yielding a combined loss of 34.75 percent of total assets (discount rate 7.75 percent minus negative 27 percent fiscal year (FY) return). Equally noteworthy is that substantial compensation and benefit concessions have been negotiated at the bargaining tables of public agencies and their represented employees. And yet, despite the actions mentioned above and the strong recovery of our State's economy, major demographic forces and structural weaknesses continue to plague CalPERS and its member agencies. As a consequence, serious challenges exist for the great majority of public agencies struggling to absorb the skyrocketing costs of public employee pensions. Pressure continues to mount on the long-term sustainability of CalPERS and the financial solvency of our municipalities.

In this context, the City Managers Department Pension Committee reconvened for the purpose of drafting a new White Paper on this topic. Our objective is to shine an even brighter light on the issues and challenges that lie ahead of us; to identify the root cause of those problems and; to offer some well-reasoned actions that if implemented, could be of significant assistance to our cities as we collectively try to work through the anticipated financial hardships of the next 10 - 20 years. Moreover, our hope is that this White Paper will assist the League's Board of Directors with its efforts to both educate and gain attention and support of employee organizations, the State Legislature and the Governor for enacting further legislative reforms or identifying alternative revenue sources to address rising costs.

PROBLEM STATEMENT

Pension costs for California municipalities have and will continue to increase at a precipitous rate for the next several years as CalPERS implements changes to reduce risk in the fund and increase the overall funded status. These changes are detailed below. In most cases, CalPERS costs have increased at a rate that has far exceeded cities' annual revenue growth.

However, the most prominent root-cause of the pension system's cost escalation began with the enhanced pension benefits granted by employers following the passage of SB 400 and AB 616 in 1999/2000. The high cost impact and retroactivity of these enhanced benefits granted without the requisite contributions to the fund, in combination with the effects of a bursting Dotcom bubble in 2001, prompted the first of many efforts by our City Managers Department to sound an alarm about the unsustainability of the new pension benefits.

To be fair, we must also acknowledge that average salaries for municipal employees grew significantly during the late 90's and early 2000's. These higher salaries and enhanced pensions, combined with CalPERS' significant investment pool losses in 2008-09 and the long, slow recovery from the Great Recession has created a huge hole for both the pension system and city budgets to climb out of. The Public Employee Pension Reform Act (PEPRA) adopted in 2012 will bring much needed relief in the years to come, but the anticipated benefits of those reforms are only applicable to new PERS members and therefore understood to be long-term in nature. They have proven to be insufficient to address the present and near-term problems.

There are many factors contributing to the rising cost of maintaining an adequately funded pension system. They are presented below:

1. **Lowering the Assumed Rate of Return (Discount Rate) on the Public Employee Retirement Fund (PERF)**
   - As legitimate as this may be, (and please know that we as city managers support it), it has the immediate effect of lowering the system's funded status and thereby requiring even larger annual contributions from employers. This could become even more burdensome to the extent that the Discount Rate is lowered below 7.0%.
   - CalPERS currently expects 5.8% annual returns until if finishes an allocation revision process scheduled for completion by July 2018. Their targeted annual return after July 2018 will be 6.2%.

2. **Limited PERF Growth Despite Positive Market Trends**
   - With seven years of positive economic growth, the PERF has only improved seven percent in terms of funded status (2008: Approx. 61% Funded; 2017: Approx. 68% funded) including the most recent 2016-17 FY estimated earnings of 11.2%.
   - Some would argue that CalPERS' investment strategy is handcuffed by an increasingly restricted list of investment options, as dictated by the CalPERS Board's ESG[1] Policy and/or by legislative action.
   - Others point to CalPERS' adoption of a funding risk mitigation policy to reduce volatility in the system (appreciated by employers) and strengthen long-term sustainability of the PERF. A strategy driven in large part by the aging demographic of its membership and the growing need to protect current assets to pay ongoing benefits.

3. **Revising Mortality Tables and other Actuarial Assumptions**
   - While mortality tables have been revised to reflect retirees are living longer, it does not fix the underfunding problem associated with existing retirees outliving the average mortality age used to compute their contributions when they were working. This serves to increase unfunded liability (Unfunded Actuarial Accrued Liability (UAAL)) and concomitantly the future costs.
   - Mortality studies have also found that there is no measurable difference in the lifespan of Safety employees, who are incentivized to retire at a younger age than their Miscellaneous counterparts.

4. **Shrinking Ratio of Active vs Retired Employees**
   - There is now, or soon will be, more retired CalPERS members receiving benefit payments in a given year than there are active employees contributing to the plan. Many of our cities' plans are in this position today.
   - In 2001, there were two active workers for every retiree. In 2016, there were 1.3 active employees for every retiree. CalPERS is predicting that within the next 10-20 years there will be 0.6 workers for every Retiree.2

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[1] *CalPERS wants 100% of their internal and external managers to have policies and procedures in place to integrate their "Environmental, Social and Governance (ESG) considerations into investment decision making.*
[2] *CalPERS "2016 Annual Review of funding levels and Risk," September 20, 2016.*

- This reality compels CalPERS to make strategic adjustments to their investment portfolio in order to ensure enough cash on hand to pay current annual benefits. We are told that, in some cases, plan assets are being sold at less than optimal market times to do this.

5. **The Perpetuation of Costly Practices and Benefit Interpretations**
   - There exists an abusive practice of relatively unencumbered use of "industrial disability retirements" for Safety personnel which can dramatically increase a city's UAAL.
   - There continues to be broad categories of "Specialty Pays" included in the calculation of an employee's final pension.
   - Automatic Cost of Living Adjustments (COLAs) for Retirees in excess of the actual rate of inflation in a given year serve to shift a larger share of the funding burden to the younger/active members in the pension system.

It should be acknowledged that SB 400 and AB 616 were not mandates on local agencies. Simply put, local agencies agreed through the collective bargaining process to adopt these enhanced formulas and the retroactivity that came with them. While local agencies at the time may have felt misled by CalPERS actuarial reports which assumed among other things a much higher rate of return, combined with regional pressures from local labor organizations and neighboring agencies to remain competitive in attracting and retaining public employees, the fact remains that virtually <u>every</u> CalPERS stakeholder has in some way contributed to the underlying cause of the situation as it stands today. However, as city leaders we are charged with finding new and innovative ways to both ensure the pension benefit promised to our employees and that we can provide essential services to the public while operating with transparency, integrity and fiscal discipline.

One of the notable consequences of these realities is that the PERF's UAAL, which is the current value of assets held in the investment pool versus the projected amount of money (liabilities) required to pay current and future benefits to its members, is well below the 75% – 85% level that most experts say is minimally appropriate. As many will recall, the PERF was deemed "Super Funded" in the late 1990's and even after the losses incurred by the implosion of the Dotcom bubble, the funded status grew back to 102% in June 2007 just prior to the Great Recession. The funded status of the overall PERF was only 70% in January 2018. The Public Agency's Pool was also at 70%.

The other notable consequence of this significant drop in funded status is that employer's (cities') Annual Required Contributions (ARC) as determined by CalPERS, are necessarily increasing to compensate for this condition. According to the League's Retirement System Sustainability Study, "rising pension costs will require cities over the next seven years to nearly double the percentage of their General Fund dollars they pay to CalPERS." Even though these increases are phased in over the next seven years, there is widespread recognition that the escalating costs are creating extreme financial hardships today.

It is now commonplace for local governments to be budgeting upwards of 70% to 80% or more of a Safety employee's salary and 40% or more of a Miscellaneous employee's salary just to fund their pensions. Ironically, this is double the contribution level that was deemed "unsustainable" by CalPERS' own Chief Actuary eight years ago.[3] Worse yet, the trend is projected to continue upward for at least six more years as shown in the following chart. (Note: Normal Cost and UAL Payment % shown are additive for each year, but the year to year changes are cumulative, not compounding.)

CalPERS' January 19, 2017 Circular Letter on Increased Contribution Rates

		Normal Cost		UAL Payments	
Valuation Date	FY Impact	Misc. Plans	Safety Plans	Misc. Plans	Safety Plans
6/30/2016	2018-19	0.25%-0.75%	0.5%-1.25%	2%-3%	2%-3%
6/30/2017	2019-20	0.5%-1.5%	1.0%-2.5%	4%-6%	4%-6%
6/30/2018	2020-21	1.0%-3.0%	2.0%-5.0%	10%-15%	10%-15%
6/30/2019	2021-22	1.0%-3.0%	2.0%-5.0%	15%-20%	15%-20%
6/30/2020	2022-23	1.0%-3.0%	2.0%-5.0%	20%-25%	20%-25%
6/30/2021	2023-24	1.0%-3.0%	2.0%-5.0%	25%-30%	25%-30%
6/30/2022	2024-25	1.0%-3.0%	2.0%-5.0%	30%-40%	30%-40%

The grave concern therefore, is that cities already in financial distress are pushed even closer to the brink of insolvency. Those cities which are not in as dire a condition are likely to reduce important programs and infrastructure investment to avoid a similar fate, but doing so may also be harming their long-term financial condition. As the ones most responsible for the financial security of our cities, we are deeply troubled, just as we were in 2003 and as we expressed more succinctly in our 2011 Pension Action Plan, we continue to believe: THIS IS UNSUSTAINABLE!

Clearly, there is important work to be done at the local level in order to avoid serious problems. At this point, we do not believe we can do it alone as the necessary structural changes toward pension system and municipal fiscal sustainability are likely going to require the California Supreme Court, the State Legislature and the Governor to help pave the way.

A PRINCIPLED APPROACH

As the discussion of this issue continues, there should be no confusion about where cities stand on the issue of retirement security for municipal employees. We believe that a safe and secure defined-benefit pension plan is an all-important component of the personal financial planning of America's and California's middle class. Moreover, we believe that Defined Benefit Plans (DBP) have proven to be the

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[3]*CalPERS Chief Actuary, Mr. Ron Seeling, in 2009 was the first CalPERS representative to publicly acknowledge the unsustainable rate of pension costs as a percentage of employee salaries with the following, now infamous quote: "I don't want to sugarcoat anything…We are facing decades without significant turnarounds in assets, decades of….what I, my personal words, nobody else's…unsustainable pension costs of between 25 percent of pay for a miscellaneous plan and 40 to 50 percent of pay for a safety plan… unsustainable pension costs. We've got to find some other solutions."*

most effective vehicle to accumulate and distribute pension benefits to employees.[4] However, the promised benefits must be reasonable, sustainable, and just as importantly, they must be dependable. To that end, we must be willing to restore the pension plan paradigm to focusing on *reasonable* retirement security and not one of providing an unreasonably generous form of deferred compensation. We believe it is in the shared interest of state and local elected and appointed leaders to come together on this issue with organized labor to identify a politically feasible and fiscally attainable resolution.

With regard to public pensions, we find as follows[5]:

1. We must recognize the importance and value of attracting and retaining high-performing public employees to design and deliver vital public services to local communities.
2. We must recognize and support the value of a reasonable, dependable, and financially sustainable, employer-employee funded DBPs for career employees; supplemented with other retirement savings options including personal savings (e.g. 457 Plan or 401a Defined Contribution Plan (DCP)).
3. Employees should incur/pay at least half of their Public Pension "Normal Costs" and be allowed to negotiate a cost-sharing of the full ARC as well.
4. Employee pensions should be portable across all public agencies to sustain a competent cadre of California public servants.

PEPRA (2013)

While our dire prognosis for public pension sustainability is sufficient reason for concern, the present condition would certainly be a lot worse if Governor Brown had not been successful in moving the Legislature to act upon the pension reform measures outlined in his "12 Point Plan" inspired by the Little Hoover Commission's report, *Public Pensions for Retirement Security*, released in February, 2011. The PEPRA was enacted by the Legislature and became effective on January 1, 2013. We applaud the Governor's and the Legislature's work in this regard. PEPRA incorporated many of the recommendations that were included in our *2011 Pension Reform Action Plan*. Among the more important of those reforms were the following:

- PEPRA pension payments are based on the average of the three highest paid years worked, eliminating the single highest year option.
- New, less generous pension formulas were created for both Safety and Miscellaneous employees, along with extending their targeted retirement ages.
- No overtime, vacation, sick leave or other "pension-spiking" provisions may be included in the calculation of final pension compensation.

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[4] *According to the National Institute of Retirement Security, dollar for dollar, a Defined Benefit Plan (DBP) yields considerably more (46%) retirement savings that a Defined Contribution Plan (DCP).*

[5] *Original draft recommendations included the following: Pension plans should be designed to enable a career public employee with 30 or more years of service to receive a minimum of 50% and a maximum of 75% of their pre-retirement income, predicated upon using the highest 3-year average salary when computing the final pension benefit. This recommendation was rejected by the League's Government, Transparency and Labor Relations policy committee and the League Board but is included here to reflect the broad spectrum of options considered.*

- Prohibits the purchase of "Air Time".
- Eliminated the provision that allowed employers to pay the member's annual pension contribution (EPMC) for new hires. EPMC can still be negotiated with "classic Members".
- Employers and their represented employees may now agree to a greater sharing of pension costs through the collective bargaining process.
- Prohibits retroactive pension benefit increases.
- Prohibits pension contribution "holidays" from the ARC.

As necessary and beneficial as these reforms may be, their influence on lowering the current and near-term costs is relatively small. In our 2011 *Pension Reform Action Plan,* we identified a list of cost-saving measures that many cities had already put in place and others could pursue through the collective bargaining process. Virtually all of those actions, which included establishing new employment tiers with less generous benefits for new employees; greater pension cost sharing by employees and; terminating EPMC benefits, were put in place well before the PEPRA bill was introduced and subsequently passed. None of these reforms; however, adequately addressed the existing UAAL for current employees, and therefore the reforms are not expected to make an appreciable difference in the time period for which we are presently most concerned (i.e. the next decade). Therefore, we continue to sound the alarm that more statutory and structural reforms are necessary to ensure the sustainability of the pension system and to assist our member cities with managing the associated costs.

The two opportunities we think would generate the most immediate and tangible savings are:

1. Employers must have a legal means (or pathway) to change/lower the prospective pension benefits of current/active employees without being required to provide an alternative benefit of equal or greater value.
2. Employers must have a legal means (or pathway) to modify the annual COLA automatically added to a retiree's pension benefit payment.

We believe that both of these authorities, if provided by the State Legislature and/or deemed permissible by the Supreme Court, could be thoughtfully and effectually applied while maintaining reasonable pension benefits for all employees and retirees.

MOVING TOWARD A SUSTAINABLE FUTURE: PEPRA 2.0

One other positive note about PEPRA is that it essentially eliminated the competition among cities to provide the best pension benefits and employee/employer cost-sharing arrangements for these new employees. PEPRA has leveled the pension playing field among cities. Under PEPRA, all employers are required to offer identical pension plans to these new employees, with all employees required to pay half of the normal cost.

Labor group pressure to increase the pension benefits for their represented employees is not an issue because that door was closed legislatively. The only flexibility for employers remains the ability to require additional cost sharing by PEPRA employees and in 2018, employers gain the option to impose additional cost sharing through the collective bargaining process. This may be an unintended consequence, but it may also provide a model and path forward for future pension changes.[6]

As mentioned previously, we also believe that employers need the authority to modify, suspend, or even eliminate the COLA benefits currently provided to retirees. This is understandably a highly controversial proposal and is certain to generate a very strong, primarily negative, response from all categories of CalPERS participants, whether currently retired or not. It should be expected that retired members in particular will "cry foul" and they will be justified in doing so. In a narrow or individual context, any measurable change to the promised benefit structure that a retiree has planned their life around will be deemed unfair and completely counter to the basic premise of a DBP retirement system. However, it frankly makes little sense to routinely raise the annual "salary" (benefit payments) for a city's retirees when the consequence of that action is to render it impractical, imprudent or truly impossible to grant any form of salary increase or COLA to a city's current, active employees or simply to maintain current services and staffing levels.

When there is no money in the budget for employee raises because an employer's ARC payments are set at an unsustainably high level; that is a serious problem. It creates the impression, if not the reality, that current employees are being unfairly burdened with the obligation to pay for the growing benefits of their retired counterparts. Moreover, it is difficult to explain to the average taxpayer how a retired public employee can receive more money in retirement (after several years of COLA's) than they were previously paid when they were working[7]. So, there is both a legitimate "fairness" question and an "equity" issue regarding balancing the intertwined interests of all the parties affected by this recommendation. Once again, we would assert that the primary purpose of a responsible retirement program is to provide our employees with a *reasonable and secure pension,* not an excessively generous form of *deferred compensation* such as is now provided by the enhanced pension plans for Classic employees. And we believe that the current shortfall in the PERF's funded status cannot be corrected in a timely way without the additional participation of retired members.

COMPETING INTERESTS CREATE A CONUNDRUM

One of the many difficulties in developing a mutually agreed upon path toward greater sustainability lies with the competing interests of the players involved. The CalPERS Board (Board), for example, is

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[6] *While the League is a staunch defender of local control in all areas, the City Managers considered that in this instance, a uniform approach may be the best way to consider any future pension changes. For example, should benefit formulas be changed prospectively, it could be implemented for all Classic Employees statewide, using the PEPRA model of a single-plan design for all employers. If done uniformly, such a change would not create an unhealthy "race to the top" in retirement benefits. This recommendation was rejected by the League's Government, Transparency and Labor Relations policy committee and the League Board but is included here to reflect the broad spectrum of options considered.*

[7] *This may apply with more frequency to a public safety retiree that worked a full career, but less to a typical miscellaneous retiree who retires at a much lower percentage of salary and therefore it would take many years (10-20 or more), if ever, before the retiree made more in retirement than they made when they worked.*

charged with fiduciary responsibility for managing the PERF assets of its members, i.e. the active and retired employees whose contributions they hold in trust. The 13-Member Board's composition has four Ex-Officio Members; six elected members; and three appointed members, one of whom is currently a local government elected official. Clearly, employee/annuitant interests are strongly represented on the Board and employer interests are in the minority, if not completely non-existent. In addition, there is no requirement that Board Members (with the obvious exception of State Treasurer Chang and Controller Yee, who are both Ex-Officio Members) have the professional training, knowledge, or expertise to oversee the management and investment of the system's billions of dollars in assets. This structural imbalance is, in our view, a governance problem that needs to be addressed.

Second, there is wide disagreement over the proper target for funded status of the assets held in trust by CalPERS. The long-standing conventional belief is that 75% - 85% funded status is reasonable and sufficient to maintain a high degree of confidence that the system will have adequate assets available to pay the benefits earned by retirees for the remainder of their lives. The logic that supports this view is that public pension systems, in contrast to private pension systems, are funded by government agencies with taxing authority and they do not run the same degree of risk of going out of business. Therefore, the importance of maintaining a 100% funded status is diminished by the reasonable certainty that the contribution of money into the system will continue indefinitely. But reputable institutions such as Stanford University and experts (Gerard Miller; John Bartel) who believe the proper goal is to reach and maintain 100% funded status. The Board has likewise established a goal of returning the PERF to 100% funded with an acceptable level of risk.[8] On its face, this seems appropriate, however there is a high price to be paid by employers and active PEPRA employees for attaining and maintaining that standard, particularly when the PERF's investment income (which is generally 2/3rds of total annual income) fails to reach or exceed the assumed rate of return. When investment returns go down or fall below projections, employer and employee contributions must go up if the funded status goal is going to be achieved. Ironically, the difficulty in achieving the assumed rate of return in recent years is caused, in part, by CalPERS' 2014 investment strategy to "de-risk" the pool's investments over time so that there is less annual volatility in employer contribution rates. But therewith comes lower returns.

Third, the setting of Discount Rate has become somewhat politicized of late and its calculation approach is often disputed. Once again, one's beliefs about the proper investment benchmark and time parameter to use for establishing the Discount Rate will significantly sway the argument here. Joe Nation at Stanford University for example, would say that a pension system below 100% funding ratio must use a "risk-free" rate of return as the discount rate for estimating its future liability. This would equate to investments held solely in U.S. Treasury Bonds or the equivalent. However, CalPERS' Investment Portfolio is comprised of multiple asset classes with an assumed rate of return that well exceeds "risk-free" Treasury Bond interest rates. So, the problem created by lowering the Discount Rate, de-risking the pool and committing to 100% in funded status, is that employer contribution rates must necessarily rise to make up for the projected shortfall. This is, in effect, the circumstance we find ourselves in now.

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[8] *CalPERS Strategic Plan | 2017-22 pg. 7*

LOCAL AGENCIES NEED LEGAL AVENUES FOR RELIEF

The "California Rule" as it is commonly known, was first established by the Supreme Court in their 1955 ruling in *Manning Allen v. City of Long Beach* wherein the Court effectively stated that an employee's vested rights to promised pension benefit(s) cannot be prospectively changed to the employee's disadvantage without the employer providing the employee with a comparable new advantage. This ruling has served to deter employers from attempting to enact future benefit changes for current employees prospectively. It has also prevented any serious consideration of retracting or modifying the benefits provided to current retirees.

Moreover, protecting public pensions has been the "Holy Grail" of public employee unions who are apt to dispute that the current circumstances are unsustainable. But in our view, there should be no disputing the fiscal reality that when a significantly larger portion of a municipalities' revenues are being utilized for the payment of employee pension costs, it correlates directly with diminished resources being available to provide the basic services that our citizenry wants and expects (See California Crowd-Out Report by Stephen D. Eide, Senior Fellow, Manhattan Institute http://www.manhattan-institute.org/pdf/cr_98.pdf). Something has to give in this situation and our fear is that there will be even louder public outcry when basic public services, such as public safety staffing and response times; infrastructure maintenance, senior services, library hours etc. are severely curtailed, leading to both unintended and undesired consequences.

In the eyes of some, a recent decision in the *Marin Association of Public Employees v. Marin County Employees' Retirement Association (2016)* a lower court opened the door to a new interpretation of contract law as it pertains to vested pension benefits. In the Marin case, the court held that the county's implementation of PEPRA's anti-pension spiking provisions with respect to employees employed prior to PEPRA's enactment did not impair a vested right even though the county had not offered employees any comparable new advantage. The court noted that *Manning Allen* stated that a comparable new advantage "should" be provided, not that it "must" be provided. The court concluded that it was permissible for the county to provide a comparable new advantage, but it was not required to do so. The California Supreme Court has accepted this case for review.

In another recent court case, *Cal Fire Local 2881 v. California Public Employees' Retirement System (2016)* the court held that PEPRA's elimination of air time for employees employed prior to PEPRA's enactment did not impair a vested right. The court adopted the *Marin Association's* analysis regarding the "comparable new advantage" requirement. The California Supreme Court has accepted this case for review as well. Governor Brown submitted a detailed brief on this case and the League also filed an Amicus Brief (https://www.cacities.org/Resources-Documents/Policy-Advocacy-Section/Hot-Issues/Retirement-System-Sustainability/League-Amicus-Brief-in-Cal-FIRE.aspx).

As of December 5, 2018 the California Supreme Court heard oral arguments in *Cal Fire Local 2881 v. California Public Employees' Retirement System.* At oral argument, the union's attorney argued that all aspects of a pension benefit as it exists on the first day of an employee's employment become vested because each aspect is a part of the promise made to induce the employee to accept the position and therefore constitutes a form of deferred compensation. The state's attorney countered this argument by citing California Supreme Court precedent holding that there is a presumption against finding that statutes – as opposed to contracts – create vested contractual rights. The state's attorney pointed out that there was no language in the statute to indicate that the Legislature intended for the benefit to vest such that it could not be eliminated or modified in the future.

The questions from the Bench seemed to indicate that the Court will agree with the state's argument on this point when it issues its ruling in 2019. If the Court does agree with the state that the right was not vested, it is not necessary for the Court to address the California rule, since the rule does not apply to benefits that are not vested.

The Court has four other cases pending on its docket that implicate the California rule. Three of those cases are being held in abeyance pending the outcome of this case. The one remaining case – *Alameda County Deputy Sheriff's Association v. Alameda County Employees' Retirement Association* – is fully briefed and can be set for oral argument anytime.

Under the California Rules of Court, once oral argument is held and the Court takes the case under submission, it has 90 days within which to issue an opinion.

Given the outcome of these two cases, there is some hope that the Supreme Court will change the long-standing interpretation of the California Rule and create a new opportunity for redirecting the unsustainable trajectory of employer/employee pension contributions. Unfortunately, there is no way to reasonably predict when and/or how long it will take to get a judicial ruling that is actionable by cities. Therefore, we believe it is incumbent upon the League's leadership to develop and offer well-reasoned and well-constructed actions for the State Legislature to consider. Ones that have some measure of broad-based support, particularly with organized labor.

If the Court does not substantially modify the California Rule, we then suggest that the League engage the public, the media, labor groups, pension experts, the Legislature, and the Governor in a collaborative way to bring forth bipartisan changes to the structure of Public Employee Retirement Law in whatever ways are deemed necessary to protect the fiscal integrity of cities and the retirement system itself. This could include sponsoring an initiative of our own design if legislative change is not forthcoming or is deemed insufficient to solve the problems we face.

WE ARE NOT ALONE

While it is not particularly comforting, it is important to know that California's pension system issues are not unique nor are they significantly worse than those confronting a large number of other states across the nation. In April 2011 the PEW Center On The States issued a report, entitled "The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs" www.pewcenteronthestates.org which revealed that in 2009 the funded status of a growing number of state pension systems (31 in all) had dropped below the Government Accountability Office's recommended level of 80%. Moreover, virtually all of these states were failing to pay the full amount of their required annual pension contributions (including California) which compounded the shortfall.

In December 2016, the Center for State & Local Government Excellence released an issue brief entitled "State and Local Pension Reform since the Financial Crisis." The report may be accessed at http://slge.org/wp-content/uploads/2016/12/State-and-Local-Pension-Reform-Since-the-Financial-Crisis.pdf. The authors from the Center for Retirement Research at Boston College found that "in the wake of the financial crisis, many state and local pension plans have reduced benefits and increased required employee contributions to curb rising employer costs.[9] Their research also showed that many states have successfully made changes in their pension system benefits for both current and new employees. The most common changes for current employees involved increasing employee contributions and cutting COLA's. The most common changes for new employees were reducing the core benefits, i.e. extending retirement ages, reducing benefit multipliers and the definition of final salary. The degree and extent to which these changes were successfully implemented correlated heavily with the relative strength of the legal protections in place in each state.

Dallas, Texas is attempting to address their UAAL pension problem through a state legislative effort that would raise the retirement age for police and fire employees to 58 from 55, eliminate COLAs, and lower a multiplier used to determine the size of officers' and firefighters' benefit checks. The city Retirement Board voted 9-0 to support the proposed legislation.

The purpose of providing the above information is simply to point out that public employee pension systems across the country are struggling to maintain financial solvency. This is pushing the systems' trustees to pursue increasingly draconian measures to lower their cost structures to protect the retirement savings of their members.

RECOMMENDATIONS ON WHERE TO FOCUS THE LEAGUE'S EFFORTS

As a general statement, we believe the focus of the League should be on helping cities successfully manage their way through the financial challenges created by the current conditions of the pension system. We acknowledge that this won't be easy to achieve, as there is always opposition to making changes that affect someone's personal finances. Nevertheless, we think it is important to push for the recommended changes now. There is no better time. Simply nibbling around the edges of this problem is not going to get it done.

To this end, we recommend as follows:

1. **Develop a strategy for how to revise the application of COLA's to retiree benefits (when/how much)**.
    a. Retirees should not be exempt from solving the present funding challenges. After all, many of these members benefitted most from the enhanced pension formulas, receiving significant increases in benefit payments virtually overnight without making additional contributions into the system. Let us not forget that the underlying premise for enhancing the pension formulas in 1999/2000 was predicated upon the false belief that the PERF could easily afford the increased benefit payments. That has proven to be a major miscalculation. Moreover, the currently high UAAL component of most employer's ARC payments is generated by the shortfall in current assets needed to make the pension payments to retirees (including COLAs).
    b. It is fair to conclude that both active and retired employees have the same fundamental interest in protecting their retirement security which can only be assured if the pension system is properly funded. If current/active employees are compelled to make larger

[9] *Jean-Pierre Aubry and Caroline V. Crawford*

contribution payments, it stands to reason that retirees should also contribute by having their COLAs reduced and/or eliminated until the funded status of the PERF returns to the desired level.

   c. This recommendation is certain to engender strong opposition from many different fronts, so there may be a need to consider a variety of approaches to implementation. Toward that end, one option could be to limit COLA adjustments to only those retirees whose annual pension compensation falls below a certain dollar threshold such as the PEPRA salary cap or the IRS pension cap.
   d. Another approach is to establish longer time parameters for retirees to be eligible for COLA adjustments, i.e. instead of an annual COLA when warranted by the change in CPI, they could be stretched out to 5-year adjustments, and they could be further limited in total amount as well, i.e. 50% of the 5-year change in CPI.
   e. Lastly, there could also be a more "case specific" qualifier that would prohibit the payment of COLAs to a given city's retirees when that city's PERF funded status is below an agreed upon level of say 90%. This would serve to incentivize the underfunded employers to pay off or pay down their UAAL as fast as possible and it would presumably generate employee support for such as well.

2. **If the Courts do not rule in a manner that enables us to rectify the existing problems, the League should initiate a dialogue with its membership regarding the cost/benefit and strength of support for the League sponsoring a statewide initiative to change the pension system in the manner described above.**

3. **Continue lobbying strategy primarily directed at the CalPERS Board, pushing for changes in their current investment strategy.**
   a. We need the CalPERS Board to understand that their efforts to reduce contribution rate volatility, to de-risk the investment portfolio and to seemingly place greater importance on their ESG policy than on their fiduciary responsibility to generate acceptable investment returns is causing too great a hardship on municipal budgets.

4. **Re-consider converting currently deemed "Classic" employees to the same benefit formula now in place for PEPRA employees, <u>for all future years of service.</u>**
   a. Should the Court rule in the manner we desire, we would contend that this is both prudent and fair. Presumably, it will require the Legislature to adopt new law(s) or amend existing ones to make the proposed change.
   b. We recommend that the League begin now with engaging affected stakeholders and soliciting input on how to appropriately construct the required legislation.

OTHER COST-SAVING MEASURES WORTH CONSIDERING

Given that the timeline for the Courts and Legislature to act may extend well beyond some city's ability to persevere through their mounting financial hardships, we have attempted to identify a few of the actions that some cities have already taken to mitigate their immediate challenges and may therefore be of assistance to other cities as well.

1. **Develop and implement a plan to pay down the UAAL as quickly as possible**.
    a. When the Discount Rate is measurably higher than what a city can earn by investing its unallocated reserve funds in the State Treasurer's Local Agency Investment Fund (currently 1.5% for the 1st Quarter of 2019) this idea warrants consideration.
    b. It is the UAAL portion of each city's ARC that is growing at a faster pace, so developing and implementing a payment schedule that expedites the payoff of this liability will reap significant dividends.

2. **Create a Pension Rate Stabilization Program**
    a. Several cities are creating a Section 115 Trust as a place for setting aside excess, unallocated reserves or year-end budget savings to having another financial tool or resource to utilize for reducing future pension costs.
    b. Work with CalPERS to determine if established 115 Trusts can be used to lower the calculated liability and annual pension costs.

3. **Change the service delivery method of certain public services**
    a. This will be a politically challenging undertaking for many cities, as it involves personnel reductions, but it is becoming commonplace to deliver certain services (such as landscape maintenance) by either outsourcing them altogether (to the private sector) or providing them through a Joint Powers Authority that may still offer PERS benefits, but at a less expensive formula or in a more cost-effective approach i.e. "shared services."

4. **Employee cost sharing of the annual pension contribution**
    a. This could be for a defined period of time or until the total ARC cost reduces to a more normal level as a percentage of payroll.

CONCLUSION

Municipal government is facing a stark reality as pension cost increases outpace revenue growth over the long term. As such, many cities across California will be forced to make difficult decisions relative to staffing and service levels. While the courts may provide some relief in the future, cities cannot continue to piecemeal our response to these realities. It is critical that we continue our efforts to and as such, should consider all options and opportunities to balance the commitment to employees with the expectations of the community.

City of Morro Bay

CalPERS Study Session

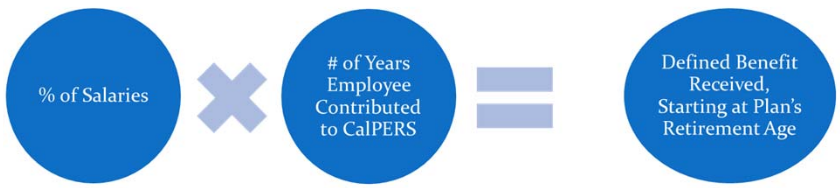
August 13, 2019

AGENDA

- Brief Background
- Reminder: How Did We Get Here?
- What Has the State/CalPERS Done to Fix the Problem?
- What is the Fiscal Health of the City's Pension Plans?
- City's Proactive Approach to CalPERS
  - What We've Done So Far
  - What We Can Do Now
- What are Other Public Agencies Doing?
- Council Questions, Discussion and Direction

BACKGROUND

- City provides retirement benefits for all full-time employees through California Public Employees Retirement System (CalPERS)
- Provide defined benefit based on:



CITY PLANS

Nine City Plans

Plan	Miscellaneous	Safety Fire	Safety Police
Classic Members	2.7% at Age 55	3% at Age 50	3% at Age 50
Tier 2	2% at 60 (Effective Dec 2011)	3% at Age 55 (Effective Mar 2011)	3% at Age 55 (Effective Sept 2011)
PEPRA Plan	2% at Age 62 (Effective Jan 1, 2013)	2.7% at Age 57 (Effective Jan 1, 2013)	2.7% at Age 57 (Effective Jan 1, 2013)

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OPEB

- OPEB – primary cost for retiree health benefits
- Participates in CalPERS Health Benefit program
- City contributes the minimum amount required by law per month – retirees pay the difference between the City's share of the cost and their plan cost.

TEN-YEAR FORECAST

City of Morro Bay Budget Forecast ($ in 000)

General Fund	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
Property Tax	$4,405	$4,537	$4,697	$4,881	$5,072	$5,230	$5,394	$5,447	$5,503	$5,558	$5,614
Sales Tax	2,012	2,166	2,192	2,208	2,191	2,175	2,188	2,208	2,247	2,282	2,328
TOT	3,531	3,567	3,602	3,639	3,675	3,712	3,749	3,786	3,824	3,862	3,901
Other Revenue	3,159	3,166	3,014	3,038	3,071	3,106	3,141	3,156	3,213	3,256	3,299
Transfers	1,256	1,405	1,648	1,670	1,692	1,715	1,738	1,738	1,738	1,763	1,789
Total Revenue	14,363	14,840	15,153	15,436	15,702	15,937	16,209	16,336	16,525	16,722	16,931
Personnel	10,376	11,050	11,338	11,657	11,934	12,158	12,363	12,651	12,963	13,301	13,669
Other O&M	3,474	3,349	3,685	3,761	3,839	3,919	4,000	4,117	4,202	4,287	4,353
Transfers/Svc Adds	513	437	634	647	660	674	713	728	743	733	749
Future Budget Cuts	0	0	0	0	0	0	0	0	0	0	0
Total Expenditures	14,363	14,836	15,656	16,064	16,433	16,750	17,076	17,496	17,907	18,322	18,771
Net Annual	0	4	(504)	(629)	(731)	(813)	(866)	(1,160)	(1,382)	(1,600)	(1,840)
Beginning Balance	38	39	43	(460)	(1,089)	(1,820)	(2,633)	(3,500)	(4,660)	(6,042)	(7,642)
Cash Adjustments	0	0	0	0	0	0	0	0	0	0	0
Ending Balance	39	43	(460)	(1,089)	(1,820)	(2,633)	(3,500)	(4,660)	(6,042)	(7,642)	(9,482)

Emergency Reserve	FY 2019	FY 2020	FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
Revenue	$236	$95	$79	$80	$80	$25	$25	$25	$25	$25	$25
Transfers Out	225	0	0	0	0	0	0	0	0	0	0
Net Annual	11	95	79	80	80	25	25	25	25	25	25
Cash Adjustments	0	0	0	0	0	0	0	0	0	0	0
Beginning Balance	2,927	2,938	3,034	3,113	3,192	3,272	3,297	3,322	3,347	3,372	3,397
Ending Balance	2,938	3,034	3,113	3,192	3,272	3,297	3,322	3,347	3,372	3,397	3,422

Total GF+ER Balance	**2,977**	**3,077**	**2,652**	**2,103**	**1,452**	**664**	**(178)**	**(1,314)**	**(2,670)**	**(4,245)**	**(6,060)**
% of GF Exp	20.7%	20.7%	16.9%	13.1%	8.8%	4.0%	-1.0%	-7.5%	-14.9%	-23.2%	-32.3%

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UNFUNDED ACCRUED LIABILITY

How did this Happen?

What are the Options?

OPEB

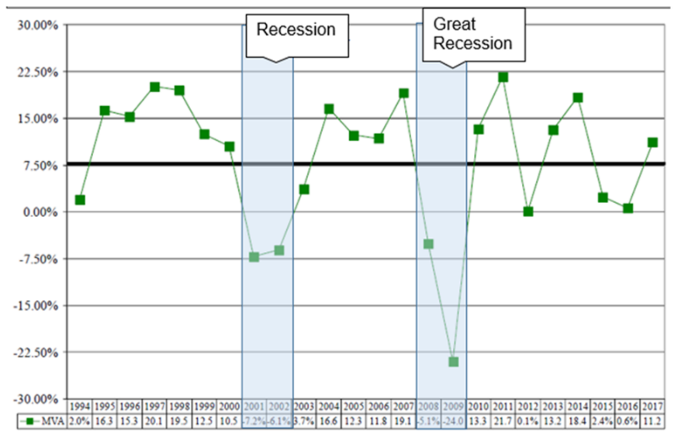
- OPEB Liability – $2.5 million

Plan's Net OPEB Liability/(Asset)		
Discount Rate - 1% -2.80%	Current Discount Rate (3.80%)	Discount Rate + 1% -4.80%
$ 2,942,775	$ 2,511,758	$ 2,167,631

HOW DID WE GET HERE?

CalPERS Past Investment Performance & Rate of Return:

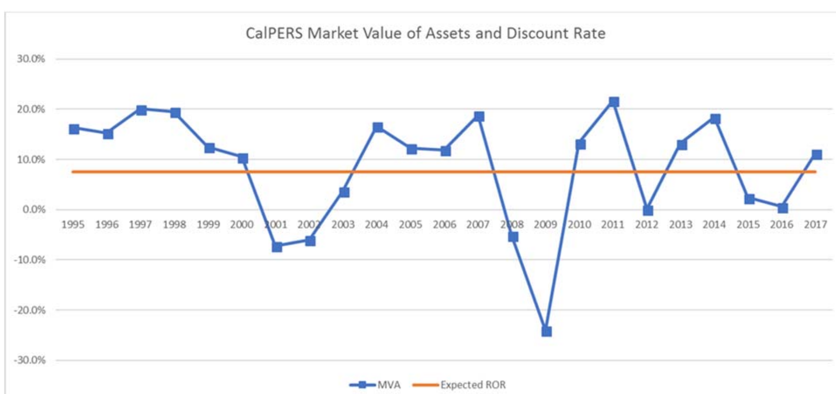
Chart 1: CalPERS Historical Investment Returns 1994 –2017



	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
MVA	2.0%	16.3	15.3	20.1	19.5	12.5	10.5	-7.2%	-6.1%	3.7%	16.6	12.3	11.8	19.1	-5.1%	-24.0	13.3	21.7	0.1%	13.2	18.4	2.4%	0.6%	11.2

Above assumes contributions, payments, etc. received evenly throughout year.

CALPERS FUNDING – INVESTMENT EARNINGS



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CALPERS FUNDING

- When CalPERS investment earnings are lower than expected, CalPERS needs to make better than expected future earnings, request higher contributions, or reduce retiree benefits
- Other Factors: demographic changes, automatic COLAs for retirees, enhanced retiree benefits

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CALPERS PENSION FUND STABILITY INITIATIVES

- 2013 – PEPRA
  - Increased Employee Contribution
  - Reduced Benefit
- FY 2014/15 – Discount Rate reduced to 7.5%
- FY 2018/19 – phase in of discount rate reduction from 7.5% to 7.0%
- Risk Mitigation Strategy
- February 2018 CalPERS changed amortization of prospective gains/losses on investments to 20 years (compared to 30 years) beginning in FY 2022, increases volatility

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MORRO BAY UNFUNDED LIABILITY

Plan	UAL	
Miscellaneous	$	12,859,550
Safety Fire	$	4,370,665
Safety Police	$	6,253,830
Total UAL	**$**	**23,484,045**

Plan (Classic Tier Only)	Funded Percentage
Miscellaneous	71.5%
Safety Fire	70.5%
Safety Police	70.7%

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MORRO BAY PENSION FUND STABILITY INITIATIVES

- Prepaid Side Fund Liabilities - $10,00 savings
- Pay annual UAL payment in one lump sum (July)
  - 18/19 Savings = $63,000
  - 19/20 Savings = $71,000
- GFER Set aside and Policy
- Additional employee cost sharing

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RECOMMENDED GUIDING PRINCIPLES FOR FUTURE STABILITY INITIATIVES

Volatility: Manage volatility of returns

Diversification of Risk

Local Control of Assets

UNFUNDED UAL OPTIONS:

Option	PROS						CONS									
	Min Pmt	Local Control	Interest Savings	Irrevocable	Defers Ints Debt	Annual Expenditure Savings	Min Pmt	Higher Pmts	Funding?	Irrevocable	Revocable	Market Volatility	Affect Debt Capacity	Requies Bargaining	Annual Financing Expense	Not a Best Practice
Status Quo	✓	✓					✓									
~~Fresh Start~~			✓	✓				✓		✓		✓				
Additional Payments		✓	✓						✓		✓	✓				
GF Reserve		✓		✓					✓		✓					
Pension Trust		✓		✓					✓			✓				
Employee Cost Sharing		✓				✓								✓		
~~Line of Credit~~					✓								✓		✓	
~~GO Bonds~~												✓	✓			✓

UNFUNDED UAL OPTIONS:

- **Fresh start of Tier 2 and PEPRA Plans – over 2 to 5 year**
- **Full pay off of Tier 2 and PEPRA Plans in Jan 2020 – approximately $480,000**
- **Prevents UAL's for Tier 2 and PEPRA plans from growing to the level that the Classic plans did**
- **Most affordable and viable option for the City at this time**

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WHAT THE CITY CAN DO NOW

- **Annual Review of CalPERS pension liability:** Annually review excess personnel and benefit savings from all funds, apply savings to CalPERS on contribute to 115 Trust.
- **Reduce Future PERS Liability and Cost**: Working through the labor negotiation process with City employees to find options to control or reduce future PERS costs.
- **Embrace Non-pensionable Compensation**: Working through the labor negotiation process offer "non-PERSable" compensation (time off, deferred compensation contributions, health contribution, etc.)
- **Voice for Pension Reform**: Continue work with the California League of California Cities and County City Managers with regards to discussions about pension reform as the current pension system is not sustainable. City Council and Labor Groups need to raise their voices too.

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WHAT ARE OTHER AGENCIES DOING TO PAY DOWN THEIR PENSION LIABILITY?

- Making at least one prepayment using excess reserves, savings from unspent payroll budget
- Policy or procedure to strategically reduce the outstanding UAL balance over time
- Establish Section 115 Trust to stabilize pension costs
- Very few have changed their amortization schedule to 10 to 20 years

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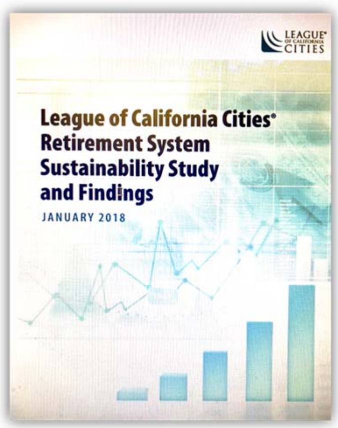
LEAGUE OF CITIES EFFORTS

- Pension Survey add pressure and helps with the narrative.
- Testimony at CalPERS
- City Manager's Department Efforts
  - White paper on proposed legislation
  - Impacts to cities



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KEY FINDINGS OF LEAGUE SURVEY

1. Rising pension costs will require cities over the next seven years to nearly double the percentage of their General Fund dollars they pay to CalPERS.
2. For many cities, pension costs will dramatically increase to unsustainable levels.
3. The impacts of increasing pension costs as a percentage of General Fund spending will affect cities even more than the state.

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Questions & Answers Council Discussion & Direction

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