<table>
<tr><td> </td><td>City of Santa Ana
Council Policy</td><td colspan="2">[signature]
Mayor's Authorization</td></tr>
<tr><td colspan="3">Subject
UNFUNDED EMPLOYEE PENSION LIABILITY COST REDUCTION POLICY</td><td>Council Approval Date:
February 2, 2021</td></tr>
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The City's contribution to fund employee pensions has increased at a faster rate than most other costs. As of June 30, 2019, pension plan assets account for only 67% of the accrued liability; and the plan administrator projects the City's contribution will continue to increase in the future. This policy addresses strategies to reduce the City's cost of its employee pension liability.

Background

The City provides a defined benefit pension plan to its full-time employees. A defined benefit is a promise to pay future benefits, wherein the City makes annual deposits into the plan and carries the risk of plan assets investment performance. If the plan's investment return is less than assumed, the City cost to provide the benefit increases.

The City has contracted with the California Public Employee Retirement System (CalPERS) to manage the employee pension plan. CalPERS collects contributions from the City and its employees, invests the money, and pays monthly benefits to retirees. Ideally, the plan would be 100% funded, which means plan assets are equal to plan liabilities. A plan with a low funded ratio is at risk for paying future promised benefits.

In response to the rising cost of public employee pensions after CalPERS investment losses during the Great Recession of 2009, and to ensure the future solvency of plans under contract with CalPERS, California enacted the Public Employee Pension Reform Act (PEPRA). All public employees hired after PEPRA became effective in January 2013 receive a lesser benefit than those "Classic" employees hired before PEPRA. Santa Ana Employees earn benefits in one of the following four categories.

1. Classic Safety (sworn public safety employees);
2. PEPRA Safety;
3. Classic Miscellaneous (all other non-sworn City employees); or
4. PEPRA Miscellaneous.

The market value of investments in the Santa Ana plan is less than the liability for benefits already earned, and the City has an Unfunded Pension Liability. Each year, the amount of the liability changes based upon actual plan results and CalPERS changes in assumptions. The liability grows when actual plan results do not meet CalPERS assumptions, such as retirees living longer than expected; or when CalPERS changes its assumptions, such as reducing the assumed rate of investment return. Conversely, the liability decreases when actual plan results exceed CalPERS assumptions, such as investments earning more than the assumed rate of return. CalPERS also charges "interest" on the unpaid liability each year, based on the plan's discount rate, equivalent to the assumed rate of return. CalPERS requires the City to make annual contributions to reduce the unfunded liability.

This policy addresses strategies to reduce the cost of the unfunded pension liability.

There are two basic strategies to reduce the City's cost for the unfunded pension liability:

1. Contribute more than required by CalPERS (an Additional Discretionary Payment) to reduce the accrual of interest; or

2. Refinance the liability, which is a legal debt of the City, at a lower interest rate.

Within these two basic strategies, there are a variety of options and associated risks.

Application of Additional Discretionary Payments

When the City identifies funding for an Additional Discretionary Payment (ADP), there is a strategy to apply the ADP to the unfunded pension liability.

The unfunded liability is comprised of layers or "bases" related to each year of actual plan results. Each base is either a loss or gain. CalPERS amortizes most of the bases over twenty years to calculate the annual required contribution to reduce the liability. Loss bases at the beginning of an amortization cycle are desirable targets for an ADP to maximize overall savings. Conversely, loss bases at the end of an amortization cycle are desirable targets to maximize short-term savings.

1. *It shall be the City's policy to use a targeting strategy, and apply any Additional Discretionary Payments to loss bases at the beginning of an amortization cycle to maximize overall savings.*

Use Accumulated Fund Balance or One-Time Money

The City has a General Fund to account for unrestricted revenue; and many other "restricted" funds to account for revenue with spending restrictions imposed by law, other governmental agencies, or legally enforceable agreements. The City allocates its unfunded pension liability to each fund based upon the prior year normal cost charged to the fund through payroll.

When the City receives more revenue than expected, or spends less than budgeted, a fund balance accumulates. Much like spending from a savings account, accumulated fund balance is a one-time resource the City can use to pay down a fund's allocation of the unfunded pension liability. The City has a separate "reserve" policy to establish the minimum fund balance to keep on hand for emergencies and operational cash flow.

2. *It shall be the City's policy to consider an additional discretionary payment to reduce the unfunded pension liability during each annual budget process, when staff identifies accumulated fund balance in excess of reserve policy requirements.*

Negotiate with Employees

Employees are already required to contribute a portion of their pay to the employee pension plan. Even though the City collects the employee contribution from the employee, the City reports the employee contribution to CalPERS as an employer-paid contribution. This increases the employee income used to calculate the City's contribution and the retiree benefit.

The City may negotiate with its labor groups to require larger contribution from employees, or to stop reporting the employee contribution as employer-paid. Both options would reduce the City's normal cost contribution, and may be difficult to negotiate without offering something in exchange.

3. *It shall be the City's policy to propose reductions of the City's normal cost contribution during labor negotiations, based upon the plan funding ratio and the City's current and forecasted financial position.*

Use Cash Planned for Capital Projects and Issue Tax-Exempt Debt

When the City has cash on hand to fund capital projects, the City may consider using the cash to reduce the unfunded pension liability, and instead issue tax-exempt debt to pay for the project. Tax-exempt debt carries a low interest rate, and this strategy effectively swaps a higher-rate debt for a lower-rate debt.

The City funds most of its capital projects with restricted money. Therefore, the restricted fund's allocation of the unfunded pension liability, and the cash available for the project, limits the use of this strategy. In addition, frequent debt issues can negatively affect the City's credit rating.

4. *It shall be the City's policy to consider paying down the unfunded pension liability when there is at least $20 million of cash available for capital projects, and it is feasible and economically prudent to issue tax-exempt debt for the projects.*

Irrevocable Section 115 Trust

As an alternative to making an ADP to CalPERS, the City can choose to set aside additional money in a Section 115 Trust. Money placed into the trust is irrevocable, meaning it cannot be withdrawn and used for another expenditure of the City. The City has already established a Section 115 Trust with an initial small deposit.

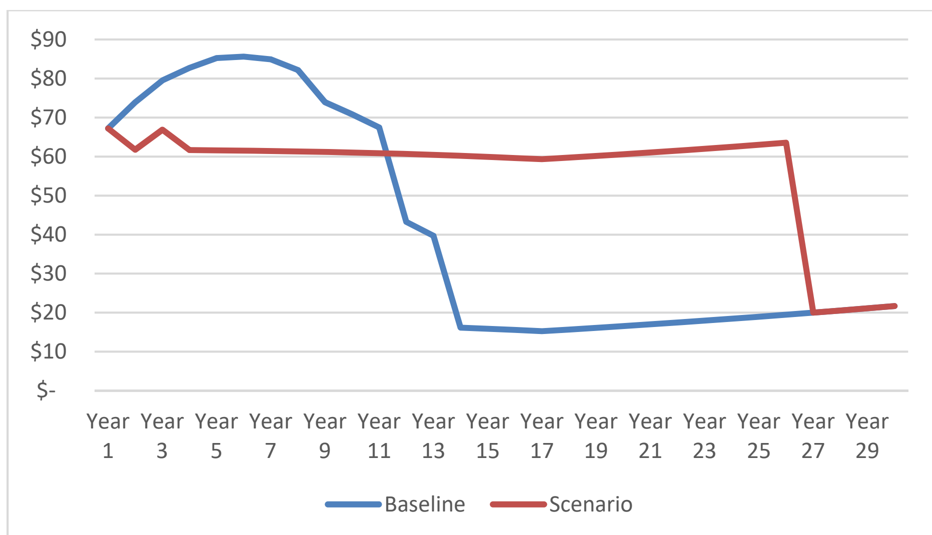
There are two primary benefits associated with a Section 115 Trust. The City has more control over the investment, and the City can use the Trust for rate stabilization. If there are future spikes in pension costs, the City could use money from the Section 115 Trust to help pay some of the required CalPERS contributions. However, in order to utilize the Trust, additional money must be set aside in advance.

5. *It shall be the City's policy to consider adding money to the Section 115 Trust account during each annual budget process.*

Pension Obligation Bonds

The City may consider issuing Pension Obligation Bonds (POBs) to refinance its unfunded pension liability. In a low interest rate environment, issuing POBs can significantly reduce the City's cost. However, there is risk associated with the refinancing. If actual pension plan results consistently exceed CalPERS assumptions over a long-term period, the City may pay more overall. The following illustrates this concept.

Scenario: The City refinances its pension obligation at 3.75%; and CalPERS assumes a 7% investment return, yet consistently earns a 9% return over a 30-year period.



Baseline is the CalPERS projection from the June 30, 2019 Actuarial Valuation Report. Dollar amounts are in millions.

For the first 11 years in this scenario, the City would save money; but over the entire 30-year period, the City would pay $444 million more.

The Government Finance Officers' Association (GFOA) issued an advisory against POBs based upon a variety of reasons such as the potential for invested proceeds to earn less than the interest owed on the bonds, structuring the debt over a longer term than the original amortization period, and the potential for the bonds to consume the agency's legal debt capacity. The following policy points can help mitigate these concerns.

6. *It shall be the City's policy to consider issuing POB's only if the following criteria exist.*
   a) *The City Council must conduct a public meeting to consider the results of an analysis quantifying the risk probability of the City paying more over the life of the bonds.*
   b) *To maximize potential savings, the bond interest rate must be at least 30% less than the plan's current discount rate.*
   c) *To ensure the City benefits from the possible scenario of actual plan results exceeding CalPERS assumptions shortly after issuing debt, the bonds must not exceed 90% of the unfunded liability.*
   d) *The bond structure must not extend the life of the debt.*
   e) *The City must not use bond proceeds to pay the normal cost of the pension plan.*