Agenda Item No. 9C
March 10, 2015

TO: Honorable Mayor and City Council Members
Attention: Laura C. Kuhn, City Manager

FROM: Laura Kuhn, City Manager

SUBJECT: DISCUSSION OF UNFUNDED LIABILITIES AND REQUEST FOR DIRECTION FROM COUNCIL

DISCUSSION:

As part of the long range financial forecast, the City has been discussing the impact of unfunded liabilities on future financial sustainability. In order to assist the discussion, a whitepaper on the issues and possible solutions for the issues is provided in Attachment 1. The City has unfunded liabilities related to its 3 pension plans and its retiree health care program. Total unfunded liabilities from all of these plans total $266 million in Fiscal Year 2014. In order to fully fund these unfunded liabilities, the City needs to make its annual required contribution for each plan as determined by an actuarial report. While the City has met the annual required contribution for all of its pension funds, it has not done so for retiree health care, falling short $4.5 million in 2013/14 and $12.5 million overall. Lack of having Council adopted programs to address these liabilities can affect the City's credit rating and ability to borrow funds, especially since the liabilities must be disclosed in its financial statements. In order to ensure fiscal sustainability of the City and to maintain the ability of the City to provide negotiated benefits to its employees, the City needs to develop a policy for achieving a level of funding for these programs.

In order to facilitate Council discussion, the whitepaper provides 3 possible programs to move toward more complete funding. Program One would move toward funding the annual required contribution for retiree healthcare over a 5-year budget period and would add one-time contributions toward catching up based upon 50% of any year end budget surplus. Program Two would continue the current pay-as-you-go method of budgeting, but dedicate part of budget surpluses while creating a new tier of retiree health benefit to future employees. Program Three would begin budgeting a portion of the annual required contribution, begin allocating a percentage of budget surpluses, create a new tier for new hires and work with employee groups to change the current contribution method toward retiree health costs. These program options are meant for discussion purposes only and any combination should be considered.

FISCAL IMPACT:

The City currently has a large unfunded liability total which will impact future budgets. If no additional financial resources are allocated, each annual budget will need to provide a larger appropriation to fund these benefits, limiting the Council's ability to provide essential services.

RECOMMENDATION:

It is recommended that the City Council direct staff to draft a policy for City Council adoption at a future meeting date that implements Program Three as a policy to address unfunded liabilities.

ATTACHMENTS:

Attachment 1: Unfunded Liabilities: Challenges and Opportunities.

CITY OF VACAVILLE

UNFUNDED LIABILITIES

CHALLENGES AND OPPORTUNITIES

DEFINING THE ISSUE OF UNFUNDED LIABILITIES

What is an unfunded liability?

As part of our annual (or biannual) actuarial reports on retirement plans and retiree health care, the actuary performs a funding status review. In performing the review, the actuary takes the present value of current assets in the plan plus future contributions and earnings and subtracts that from the present value of all retirement or health care obligations. The present value of an obligation represents taking a stream of payments out to provide a benefit and discounting it back to present day dollars if you were to pay the amount today. If assets equal or exceed the liability, the plan is fully funded; if not, the plan has an "unfunded liability". A current example is provided below from one of the City's retirement plans:

Total Pension Liability	$226,007,308
Market Value of Plan Assets	$144,155,092
Unfunded Liability	$ 81,852,216
Funded Ratio (Plan Assets / Total Pension Liability)	63.8%

So, an unfunded liability is a bad thing?

Not necessarily, while it would be ideal to have 100% funding, liability funding is a moving target and it is highly unlikely to be at 100% at any given time. This is because the factors affecting the actuarial analysis can change regularly; such as salary, investment return, life expectancy and benefit level. Instead, unfunded liabilities are amortized over a period of time and included in future retirement contribution requirements. While it is important to make sure the unfunded figure does not become unmanageable, a reasonable approach to fund the liability over a period of time.

Many factors can affect the amount of the unfunded liability: new benefits given retroactively, good or bad investment performance, a change in actuarial assumptions and changes in employee salaries or health care costs can all have positive or negative impacts on the unfunded liability. In addition, like a home mortgage, the amortized cost of unfunded liabilities creates an additional expense for the City in the form of interest for each year the liabilities are outstanding. Since the plan isn't 100% funded, the amounts not in the account are not earning investment earnings, so the amortized costs includes the cost of lost investment earnings also (7.5% for our plans).

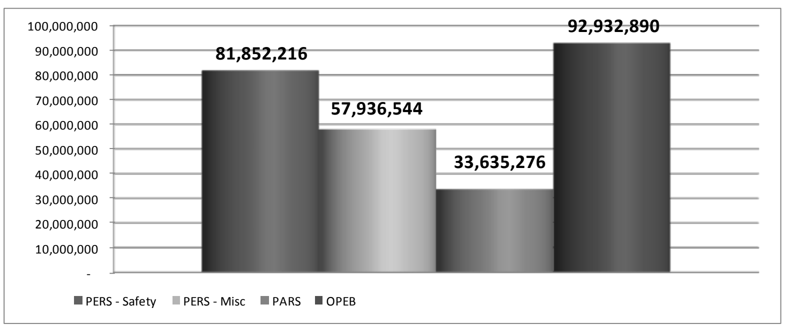
Just like a mortgage, any unfunded amounts you pay down earlier will not only reduce the amount by that total, but also by the amount of interest you would not have to pay for those remaining years. Many factors can affect the amount of the unfunded liability:

new benefits given retroactively, good or bad investment performance, a change in actuarial assumptions and changes in employee salaries can all have positive or negative impacts on the unfunded liability of the CALPERS plan. In addition, like a home mortgage, the amortized cost of unfunded liabilities cost the City interest for each year they are outstanding. Since the plan isn't 100% funded, the amounts not in the account are not earning investment earnings, so the amortized costs includes the cost of lost investment earnings also (7.5% for our plans).

Just like a mortgage, any unfunded amounts you pay down earlier will not only reduce the amount by that total, but also by the amount of interest you would not have to pay for those remaining years.

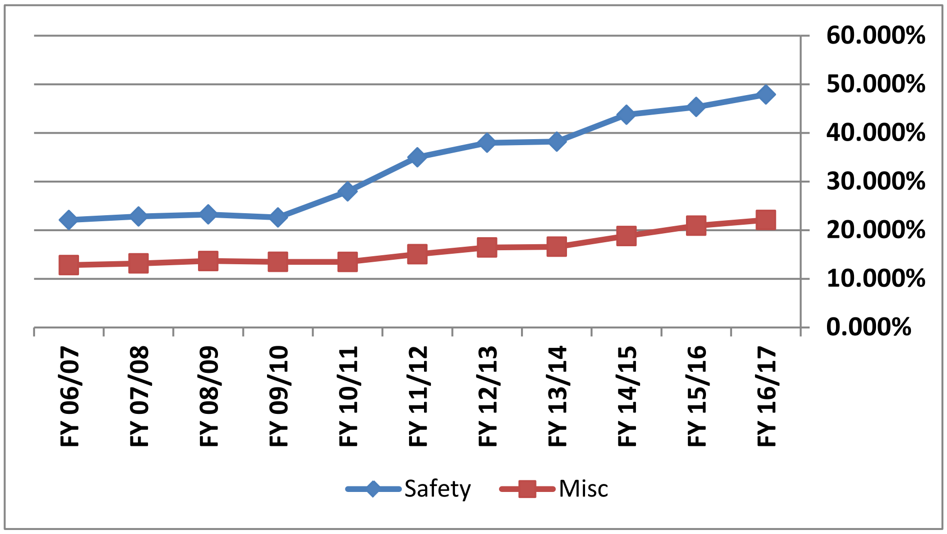
How many unfunded liabilities does the City have and how much are they?

The City has three individual retirement plans and a retiree health care plan (referred to as OPEB). Each of those plans currently has an unfunded liability which taken together total $266.3 million. A brief discussion of each unfunded liability is provided below.



CALPERS

The City currently has two plans with the California Public Employee Retirement System commonly referred to as CALPERS. One plan is for our public safety employees and the second plan is for all other employees and is referred to as the miscellaneous plan. Our annual required contribution (ARC) to CALPERS is expressed as a percentage (%) of payroll and the chart below shows the trend of that cost over time.



While useful for trending, percentage of payroll does not effectively communicate the budget impact of the pension cost. Below is a table showing the actual monetary amounts:

ANNUAL PENSION COSTS

	Safety			Miscellaneous			
	Normal Cost	**Unfunded Cost**	**Total Cost**	**Normal Cost**	**Unfunded Cost**	**Total Cost**	**GRAND TOTAL**
2015-16	$ 3.8	$ 5.3	$ 9.1	$ 2.1	$ 3.4	$ 5.5	$ 14.6
2006-07	$ 2.1	$ 0.8	$ 2.9	$ 2.0	$ 1.2	$ 3.2	$ 6.1
				Increase in contribution			**$ 8.5**

source: CALPERS Actuarial Reports
expressed in millions (x,000,000)

While the normal costs have risen considerably in the Safety plan due to benefit enhancements, the unfunded cost is now the key driver in actual CALPERS costs. Those increases have resulted in an $8.5 million increase in annual costs to the City.

The City has met its annual required contribution for the CALPERS plans and both are in good standing, so any additional amounts would be applied towards paying down the unfunded balances. However, it should be noted the total unfunded liabilities of the two plans total $139.8 million, so any contributions would change those amounts incrementally.

PARS

The City has an additional defined benefit program through the Public Agency Retirement System (PARS), which provides a supplemental plan to the Miscellaneous CALPERS plan.

ANNUAL PARS COSTS			
	Miscellaneous		
	Normal Cost	Unfunded Cost	Total Cost
2015-16	$ 1.0	$ 2.8	$ 3.8
2006-07	$ 0.9	$ 1.3	$ 2.2
Increase in contribution			$ 1.6

source: Actuarial Reports Milliman Group
expressed in millions (x,000,000)

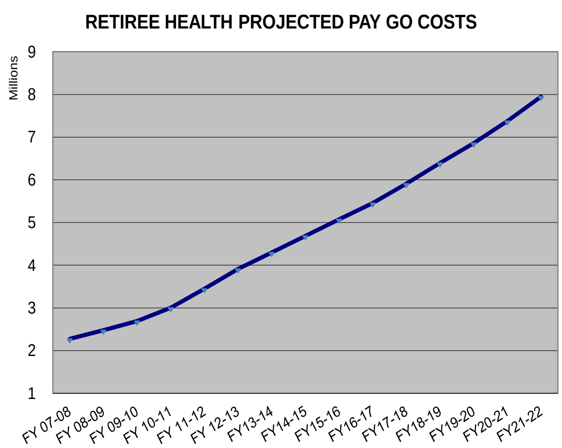
While the normal costs for the PARS program have risen slowly in the period, unfunded costs have more than doubled in the plan. This reflects the unfunded costs of retroactive implementation of the PARS program and investment losses during the recession. A current unfunded cost for the PARS plan is $33.6 million.

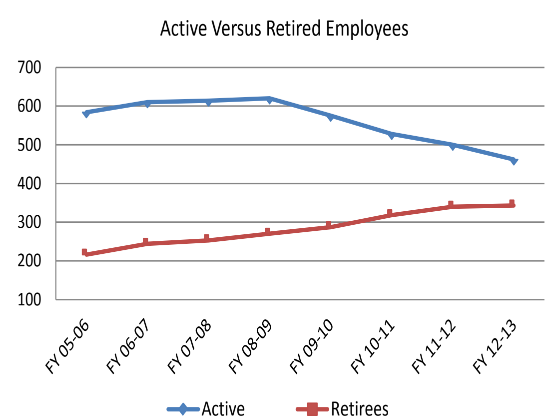
The City has always met its annual required contribution for the PARS plan and the plan is in good standing.

Post-employment Health Benefits (OPEB)

The City offers a retirement health insurance program for employees that retire from the City. Prior to 2009, a person who retired from the City past the age of 50 would be provided a retirement health insurance premium contribution equal to that of active employees. For those employees who were hired after January 1, 2009, there is a vesting period, whereby there is no earned benefit until the employee has worked five years with the City and a minimum of ten years at a public agency in CALPERS to receive 50% of the insurance premium.

For many decades, the City has paid for retiree health care costs on a pay-as-you-go basis (PAYGO). As part of the annual budget, the City funded an amount required to pay for the cost of retiree health care. Health care cost increases combined with an increasing number of retirees, are showing that the PAYGO approach will exacerbate challenges in the near future. As an example, in the year 2000 there were 5.1 active employees for every retiree with health care. In 2013, there were 1.3 active employees for every retiree with health care.





To address this funding challenge, in 2010 the City created a retirement health care trust fund to set aside funds to offset future funding costs of retiree health. The retirement trust performs an actuarial valuation every two years to assess the funding progress of the retirement trust towards funding the retiree health care liability over a thirty year period. The annual required contribution (ARC) for the trust is represented by the current PAYGO costs, plus an amount to be set aside to fund future benefits. The difference between the ARC and the actual contribution is called the asset liability and represents the amount the City is in arrears towards fully funding its liability. As you will note, unlike all of the City's retirement plans, the City is currently $12.68 million dollars behind in fully funding its retiree health care long term liability. If the City would begin to fully fund the ARC it would be equivalent of 21.98% of payroll.

	ARC	Actual	Asset Liability
FY 09-10	5,650,000	4,640,000	570,000
FY 10-11	6,460,000	4,040,000	2,990,000
FY 11-12	7,130,000	4,380,000	5,740,000
FY 12-13	7,600,000	5,090,000	8,250,000
FY13-14	9,535,000	5,116,000	12,684,000
(2014 ACTUARIAL)			

There is currently no requirement to fund the retiree health care ARC or the unfunded liability, however sound financial practices would dictate the City should develop a funding policy to prevent the PAYGO costs from becoming a threat to having funds available for City operations.

Financial Reporting of Unfunded Liabilities

Prior to the 2014-15 fiscal year, retirement and retiree health care liabilities were reported in the financial footnotes to the City's financial statements and then only in the financial statements themselves, if the City was not paying its annual required contribution towards full funding. In the City's 2013-14 Comprehensive Annual Financial Report (CAFR), a net OPEB obligation of $12.68 million is shown in the Statement of Net Position which represents the amount the City is in arrears towards funding retiree health care liabilities.

Beginning in the 2014-15 fiscal year, Governmental Accounting Standards Board Statement Number 68 (GASB 68) changes the reporting methodology for retirement unfunded liabilities. GASB 68 requires the unfunded liability to be disclosed on the face of the City's financial statement based upon the funding status of the plan. The City is working closely with CalPERS and PARS to ensure the required information will be available in time to be included in the City's Comprehensive Annual Financial Report. The most recent actuarial valuations report that the City will be adding approximately $173,424,036 in liabilities to the City's Statement of Financial Position. When fully implemented next year, we will further evaluate the impact to the financial statements, however, this large of a liability will likely make the City's unrestricted net assets a negative amount.

The Governmental Accounting Standards Board has also issued a technical bulletin for the accounting of other post-retirement employee benefits (OPEB) which includes retiree health care. As proposed, the effective date will be in 2017 and would provide the same financial reporting requirements for OPEB as the current GASB 68 does for retirement plans. If implemented in 2017, this yet to be approved pronouncement would add an additional $92,932,890 in liabilities to the Statement of Financial Position and potentially make the City's unrestricted net assets a further negative amount.

While these liability positions for retirement plans and retiree health care will negatively impact the City's Statement of Financial Position, the larger concern is the impact this new reporting requirement will have on the City's credit rating and ability to utilize financing tools in the future. All governments will be required to comply with these pronouncements, so there will be a broader discussion in the financial industry for evaluating these impacts. This is a developing issue the City will need to follow closely in the next few years and be prepared to explain to multiple stakeholders how the unfunded liabilities will be addressed.

UNFUNDED LIABILITIES POLICY DEVELOPMENT

Reporting requirements of large unfunded liabilities will significantly affect the City's financial well-being in the near and long term. For financial sustainability, the City needs to develop a comprehensive policy to communicate how unfunded liabilities will be addressed. Any policy should first address meeting all of the City's annual required contributions to prevent adding to the existing unfunded liability and then address full funding. While the City is meeting its annual required contributions with all pension funds, it is falling short $4.5million short annually on its retiree health care fund.

Below are three programs for the City Council's consideration. Selecting one option or a combination of options will allow staff to complete a draft policy for Council consideration.

Program 1 – Phase in retiree health care ARC and catch up unfunded liabilities with a percentage of any budget surpluses.

Program 1 would phase in the full payment of the health care ARC by increasing the budget allocation in five consecutive budget years to eventually budget to full ARC. In addition, the program would dedicate 50% of any general fund budget surplus to make one-time catch up payments for the shortfall in past years' required contributions. While this approach would address the retiree health care funding issue long-term, adding $15 million in new retiree health care funding over five years is forecasted to leave the general fund reserves below the Council's policy.

Program 2 – Continue to budget for PAYGO and use any budget surplus to pay towards unfunded liabilities while negotiating a new tier of retiree health care for new employees.

Program 2 will continue current budgeting practices, but include a policy that all or a significant portion of the general fund budget surplus each year will be dedicated to unfunded liabilities. This will not accomplish retire health care ARC funding, but will allocate funds towards the funding process above current levels and will begin to accumulate funding. Creating a new tier for new hires will reduce the growth rate of the unfunded liability and position the City to catch up in the future. Any new tier consideration would need to be carefully structured to meet any PEHMCA requirements.

Program 3 – Adopt a four-legged stool approach to funding.

Program three will take a four legged stool approach to funding unfunded liabilities. On the first leg, the City will begin budgeting a portion of the ARC for retiree health care into the budget process. On the second leg, the City will begin allocating a portion of any annual budget surpluses or one-time funds towards catching up the unfunded liabilities. The third leg will be to work with the labor groups to change the employees' current retiree health care contribution to reflect a percentage of payroll approach for all employees in lieu of the current 8% of Kaiser Medical Rate for those who have health insurance through the City. The fourth leg would create a new tier for new hires which will reduce the growth rate of the unfunded liability The combination of the four approaches would create a stream of funding sources which will begin to close the gap of the ARC for retiree health care that will be both level and one-time contribution sources.

Recommendation

Staff recommends the City direct staff to draft a policy for City Council adoption at a future meeting date that implements Program Three as a policy to address unfunded liabilities.