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**Title:** SUBJECT: Discussion of Options for Funding the Section 115 Post Employment Benefit Trust Fund and Request for Authorization of Funding, Determination of Preferred Asset Allocation, and Adoption of Investment Guidelines for the Section 115 Post Employment Benefit Trust

REPORT IN BRIEF

Provides direction to staff regarding the funding of the Section 115 Post Employment Benefit Trust, Also requests a determination of asset allocation, and Adoption of investment guidelines for the Section 115 Post Employment Benefit Trust.

RECOMMENDATION

City Council - Adopt a motion:

- A. Approving the dissolution of Fund 073 Revenue Stabilization Fund and transferring \$3,200,000 into the Section 115 Post Employment Benefit Trust Fund; and,
- B. Authorizing a Supplemental Appropriation from the unreserved, unencumbered fund balance in Fund 553-Wastewater System in the amount of \$2,000,000 and transferring into the Section 115 Post Employment Benefit Trust Fund; and,
- C. Authorizing a Supplemental Appropriation from the unreserved, unencumbered fund balance in Fund 557-Water System in the amount of \$1,300,000 and transferring into the Section 115 Post Employment Benefit Trust Fund; and,
- D. Directing staff to begin the process for a charter amendment to remove Section 1112 Cash Basis Fund; and,
- E. Selecting the Conservative asset allocation for the Trust 115 Post Employment Benefit Trust Fund Investment Portfolio; and,
- F. Approving Investment Guidelines to be used for the Trust 115 Post Employment Benefit Trust Fund Investment Portfolio; and,
- G. Authorizing the Finance Officer to make the necessary budget adjustments.

Sponsors:

Indexes:

Code sections:

**Attachments:** 1. Investment Guidelines Document

Date	Ver.	Action By	Action	Result
2/19/2019	1	City Council/Public Finance and Economic Development Authority/Parking Authority	approved	Pass

*Report Prepared by: Venus Rodriguez, Finance Officer*

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- D. Directing staff to begin the process for a charter amendment to remove Section 1112 Cash Basis Fund; and,
- E. Selecting the Conservative asset allocation for the Trust 115 Post Employment Benefit Trust Fund Investment Portfolio; and,
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**ALTERNATIVES**

- 1. Adopt as recommended by staff; or
- 2. Refer back to staff with specific direction, or
- 3. Deny

**AUTHORITY**

City of Merced Charter Article VI Section 604-Finance Officer-Power and duties, Charter Section 1003, Elections Code Section 9255 and 1415, and Government Code Section 53216

**CITY COUNCIL PRIORITIES**

As provided for in the 2018-19 Adopted Budget to mitigate the increasing pension obligation and

unfunded accrued liability.

## DISCUSSION

On January 7, 2019, the City Council adopted Resolution 2019-04 authorizing the Post Employment Benefit Trust for pre-funding pension obligations. At that time, staff told the City Council an agenda item would come back at a later date to make a recommendation for funding the trust, selecting the preferred asset allocation for the investment portfolio, and recommending any necessary actions regarding the ability to invest in the Trust 115.

Based on CalPERS Annual Valuation report dated June 30, 2017, the City of Merced's Unfunded Accrued Liability (UAL) is \$81.4 million. Staff estimates that the City of Merced's overall annual contribution amount will increase from \$6.4 million in fiscal year 2016-17 to \$13.5 million in fiscal year 2023-24, experiencing a 111% increase over the next six years. The General Fund's portion of pension contribution will increase from \$3.6 million in fiscal year 2016-17 to \$7.1 million in fiscal year 2023-24, with an increase of 99%.

### Initial Funding

Staff recommends initial funding to come from three sources based on a percentage allocation of the UAL and if funds are available.

#### 1. Fund 073-Revenue Stabilization

During the budget process for Fiscal Year 2016-17 the City Council approved establishing Fund 073 Revenue Stabilization. The Revenue Stabilization Fund was created to make funds available in anticipation of the next economic downturn. Annual funding to date totaling \$3.2 million dollars has come from a portion of the General Fund unappropriated balance in excess of the Government Finance Officers Association (GFOA) recommended minimum reserve balance. The General Fund makes up over \$40 million (50%) of the City's UAL. Staff feels it is appropriate and fiscally prudent to transfer all \$3.2 million into the Trust 115 and dissolve the Revenue Stabilization Fund.

#### 2. Fund 553-Wastewater Operations

The Wastewater Operations Fund had a Fiscal Year 2017-18 ending balance of \$34.7 million. Although the most current Sewer Rate Study has expired, the financial model forecasts for 10 years. The 2010 Sewer Rate Study estimated the balance of the Wastewater Operations Fund would be \$26.4 million at the end of Fiscal Year 2017-18. Most of the large balance is due to projects budgeted but not completed that will roll into future years for completion. The Wastewater Operations Fund makes up \$6.6 million (8.1%) of the City's UAL. Staff has determined that \$2 million is available to transfer into the Trust 115.

#### 3. Fund 557-Water Operations

The Water Operations Fund had a Fiscal Year 2017-18 ending balance of \$30 million. The current Water Rate Study estimated the balance of the Water Operations Fund would be \$19.7 million at the end of the Fiscal Year 2017-18. Most of the large balance is due to projects budgeted but not completed that roll into future years for completion. The Water Operations Fund makes up \$4.3 million (5.25%) of the City's UAL. Staff has determined that \$1.3 million is available to transfer into the Trust 115.

All other funds, which have an allocation of the UAL were analyzed and determined to have

insufficient funds at this time to be able to contribute to the Trust 115.

The expected benefits in funding the Trust 115 include:

- Contributions placed in an exclusive benefit trust could address the City's Net Pension Liability
- Investment flexibility compared to restrictions on City fund investments
- Oversight and control of fund management selection and monitoring of performance
- Increased flexibility on use of trust assets
- Potential for positive rating agency and investor consideration

### Annual Funding

The budget submission for each year currently includes a recommendation for a General Fund contribution to the Revenue Stabilization Fund of the calculated 75% excess of prior year audited unreserved General Fund balance over the GFOA recommended minimum. This recommendation will continue each year but instead of transferring to the Revenue Stabilization Fund, it will transfer to the Trust 115.

Example:

Fiscal Year 15-16 audited unreserved fund balance at June 30	\$8,659,009
Fiscal Year 17-18 GFOA Recommended minimum	<u>6,681,022</u>
Excess over GFOA Minimum	\$1,977,987
Amount Rounded	\$1,900,000
	<u>75%</u>
75% of Excess	\$1,425,000
80% of 75% excess to Trust 115 for Pension	\$1,140,000
20% of 75% excess to Economic Development Opportunity	<u>285,000</u>
Total	\$1,425,000

In addition, staff will analyze annually all funds, which have an allocation of the UAL to determine if funding is available to transfer into the Trust 115.

### Charter Amendment

The City of Merced Charter includes Section 1112-Cash Basis Fund, which states:

"The City Council shall maintain a revolving fund to be known as the "Cash Basis Fund", for the purpose of placing the payment of running expenses of the City on a cash basis. An operating reserve shall be built up in this Fund from any available sources in an amount that the City Council deems sufficient with which to meet all lawful demands against the City for the first five months, or other necessary period, of the succeeding fiscal year prior to the receipt of ad valorem tax revenues. Transfers may be made by the City Council from such Fund to any other fund or funds of such sum

or sums as may be required for the purpose of placing such funds, as nearly as possible, on a cash basis.

All moneys so transferred from the Cash Basis Fund shall be returned thereto before the end of the fiscal year.”

The Finance Department established Fund 002 Cash Basis and transferred \$4,000,000 from the General Fund in order to comply with Section 1112 of the Charter. The purpose of the funding was to have cash flow to cover expenses due to the timing city receives certain large revenues. For example, the City does not typically receive installments of revenues from property taxes until January and April of each fiscal year.

The City currently pools cash of all funds for investment purposes. Since its inception, the City has only used \$329,219 of the funds in 1999 for Fund 021-Street Trees. The City’s investment portfolio averages \$160 million, of which \$20 million is kept in the Local Agency Investment Fund (LAIF) with the State of California on a consistent basis. The funds kept in LAIF can be easily liquidated if needed.

If the City Council would like to utilize these funds to contribute to the Trust 115, staff would need direction to begin the process of a Charter amendment to remove Section 1112.

Amendments to the existing city charter require a majority vote of the electors and can be proposed by a governing body (i.e. City Council) or by an initiative. Section 1003 of the City’s Charter specifies that all City elections are to be held pursuant to the procedures set forth in the Elections Code of the State of California. The Elections Code requires the amendment be submitted to voters at a “General Election” and the order of election be called by Council at least 88 days before the election. The next “General Election” will be on November 3, 2020.

There is an exception to the above rule. If the proposed charter amendment does not alter any procedural or substantive protection, right, benefit, or employment status of any local government employee or retiree of any local government employee organization, then the amendment can be submitted to the voters at a statewide primary election. Since this amendment would meet this exception, the earliest it could be placed on the ballot is March 3, 2020. The order of election will need to be passed by the City Council prior to Friday, December 6, 2019.

Asset Allocation

PARS provides flexibility to the City in the selection of the investment strategy for its funds in the Trust, giving the City control on the level of risk on its investments. The City has the ability to select one of five investment options that best suits its needs. Each investment option allocates the assets in varying investment combinations of equity, fixed income, and cash. With each investment option, as the expected rate of return increases so does the assumed risk.

The asset allocation strategies and the corresponding investment options currently available are:

	Equity	Fixed Income	Cash
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Conservative	5%-20%	60%-95%	0%-20%
Moderately Conservative	20%-40%	50%-80%	0%-20%
Moderate	40%-60%	40%-60%	0%-20%
Balanced	50%-70%	30%-50%	0%-20%
Capital Appreciation	65%-85%	10%-30%	0%-20%

In November 2018, the Five Year Forecast was presented to the City Council, which showed that the significant increases in pension will create expenses over revenue in the General Fund and Measure C in most of the years. Due to the financial forecast and the likelihood of a recession, staff in conjunction with Highmark Capital Management, is recommending the conservative asset allocation.

Selecting the conservative asset allocation will provide more liquidity in case the funds are needed in the next few years. If, after a couple of years the funds in the trust have not been needed, staff and consultants will re-evaluate and could propose to the City Council a change to the asset allocation.

### Investment Guidelines

The City of Merced currently has an adopted Investment Policy, which adheres to Government Code Section 53646. All pooled cash from all City funds are invested conforming to all state and local statutes governing the investment of public funds.

The investment restrictions that apply to public funds are not applicable to assets held in the Trust 115. Assets held in the Trust 115 can be invested per Government Code Section 53216. This code allows for increased risk diversification yet invested in a prudent fashion. Therefore, approving an Investment Guideline to be used specifically for the Trust 115 is recommended in order to meet the city's objectives.

The purpose of the attached Investment Guidelines Document is to:

- Facilitate the process of ongoing communication between the Plan Sponsor and its plan fiduciaries;
- Confirm the Plan's investment goals and objectives and management policies applicable to the investment portfolio identified below and obtained from the Plan Sponsor;
- Provide a framework to construct a well-diversified asset mix that can potentially be expected to meet the account's short- and long-term needs that is consistent with the account's investment objectives, liquidity considerations and risk tolerance;
- Identify any unique considerations that may restrict or limit the investment discretion of its designated investment managers;
- Help maintain a long-term perspective when market volatility is caused by short-term market movements.

The objectives and constraints identified in the Investment Guidelines are based on selecting the

conservative asset allocation and the potential to use funds in a shorter time frame.

**Investment Time Horizon:** Intermediate-Term 3 - 5 years

**Anticipated Cash Flows:** Assets in the Plan will seek to mitigate the impact of future rate increases from CalPERS. It is not anticipated that the Plan will see a high level of disbursements in the first three years of the Plan. However, situations may arise, leading to a disbursement in assets to the CalPERS Trust.

**Investment Objective:** The primary objective is to maximize total Plan return, subject to the risk and quality constraints set forth herein. The investment objective the Plan Sponsor has selected is the Conservative Objective, which seeks to provide a consistent level of inflation-protected income over the long-term. The major portion of the assets will be fixed income related. Equity securities are utilized to provide inflation protection.

**Risk Tolerance:** Conservative

The account's risk tolerance has been rated Conservative, which demonstrates that the Plan can accept low price fluctuations to pursue its investment objectives.

### Withdrawals

In order to withdraw funds from the Trust 115, the Finance Officer, as Plan Administrator, would need to submit a written request to PARS, including verification of pension costs. The city can direct PARS to reimburse the City or transfer funds directly to CalPERS. It is a simple process and can be completed within 7-10 business days.

At this point, staff recommends reviewing the need for Trust 115 funding on a year-by-year basis. Any withdrawal recommendation will be proposed to the City Council during the budget process or as a separate City Council agenda report action item.

## **ATTACHMENTS**

1. Investment Guidelines Document