DATE: October 21, 2024

TO: Mayor and Members of the City Council
President and Members of the Estero Municipal Improvement District (EMID) Board of Directors

VIA: Stefan Chatwin, City/District Manager

FROM: Waqas Hassan, Assistant Finance Director

DEPARTMENT: Finance

SUBJECT: ESTABLISHMENT OF TAX-EXEMPT IRC SECTION 115 IRREVOCABLE TRUST; SELECTING THE PUBLIC AGENCY RETIREMENT SERVICES (PARS) AS THE TRUST ADMINISTRATOR; APPROVING "GROWTH" INVESTMENT STRATEGY; APPROVING THE FUNDING OF $286,294 AND THE APPROPRIATION IN ACCOUNT NO. 508-0460-999-4155

RECOMMENDATION

It is recommended that the City Council/Board of Directors adopt the attached resolutions to do the following:

1. Establish a tax-exempt IRC Section 115 Irrevocable Trust;
2. Select Public Agency Retirement Services (PARS) as the Trust administrator;
3. Authorize the City/District Manager (or successor/designee) to:
   (a) approve the agreement with PARS,
   (b) be the City's/District's Plan Administrator, and
   (c) execute all necessary documents to establish the IRC Section 115 Irrevocable Trust,
4. Approve the "Growth" investment strategy;
5. Approve the Initial Funding of $286,294; and
6. Approve the Appropriation in Account No. 508-0460-999-4155 for $286,294

EXECUTIVE SUMMARY

During the FY 2024-25 budget preparation process, the Council[1] expressed interest in establishing and funding the IRC Section 115 irrevocable trusts for its Longevity and Public Employees Medical and Hospital Care Act (PEMHCA) and Other Post-Employment Benefits (OPEB) plans and directed staff to bring forth plans and providers for the City Council's consideration. As of June 30, 2024, unfunded actuarial liability for the Longevity plan is $3,059,419 and for PEMHCA retiree health benefits plan is $8,980,061. Staff, after contacting a few agencies providing trust services, have determined that establishing a trust, through its investment returns, will result in lowering the unfunded liabilities of these benefits plans.

However, liability for the City's Longevity benefits plan, which is governed by the Governmental Accounting Standards Board (GASB) statement No. 73 (GASB 73), is not eligible to be funded through a Section 115 Trust since Section 115 Trust is not structured to address non-qualified pension liabilities. Therefore, the City would not be able to use the Section 115 Trust for the City's longevity liability.

BACKGROUND/ANALYSIS

The City has internal services funds for both its Longevity Recognition Benefits and its PEMHCA Benefits Plans. The Fund Balances in each of these funds represent funds set aside for post-employment liability. The current practice is to assess estimated pay-as-go annual benefit charges to applicable departments. To fund each plan's benefits, the City Council had previously established Internal Service Funds and authorized initial transfers from the General Fund, Enterprise Funds, and other Internal Service Funds to the Longevity Recognition Benefits and PEMHCA Benefits Internal Service Funds. Currently, internal service charges are assessed to the applicable departments "receiving" Longevity and/or PEMHCA benefits. Fiscal year 2024-25 total Longevity and PEMHCA assessment charges are $222,720 and 257,760, respectively.

From an accounting perspective, even if the City Council were to commit the fund balance in the Longevity and PEMHCA internal services funds to address the City's OPEB liability, the fund balance would not be factored into the calculation of the net OPEB liability, as the City would maintain control over the funds. To have eligible funds included in the calculation of the net OPEB liability, the City must remit funds to an irrevocable IRC Section 115 Trust, such as the California Employers' Retiree Benefit Trust (CERBT), administered by the California Public Employees' Retirement System (CalPERS), or through the Public Agency Retirement Services (PARS) etc.

Based on an analysis performed by the City's actuarial firm, Precision Actuarial Inc., the projected Unfunded Accrued Actuarial Liability (UAAL) for the fiscal year that ended on June 30, 2024 was $3,059,419 for the Longevity benefits plan and $8,980,061 for the PEMHCA retiree health benefits plan. The UAAL is the difference between assets (of which City has none since there are currently no funds placed in an irrevocable trust) and the actuarial accrued liability (AAL). As of June 30, 2024, the fund balance of Longevity Benefits Internal Service Fund (Fund 507) is approximately $2.8 million and

[1] All references to the City Council or City shall include the Estero Municipal Improvement District Board of Directors and the District.

approximately $6.6 million for the PEMHCA fund (Fund 508). However, as stated above, these fund balances are not considered towards the calculations of unfunded liability since these are not placed in an irrevocable trust.

Staff contacted different trust administrators who reviewed the City's GASB 73 Longevity Recognition Plan valuation and have determined that the PARS Section 115 Trust is not structured to address non-qualified pension liabilities. Therefore, the City would not be able to use the PARS Section 115 Trust for the City's longevity liability. Considering this, City will continue its current practice to address the Longevity benefits plan through the annual budget process.

Section 115 Trust:

Establishing a Section 115 Trust is generally considered beneficial for unfunded liabilities whether from Pension or OPEB plans governed by GASB Statements 68 and 75, respectively. A Section 115 Trust is a tax-exempt investment vehicle authorized by the Internal Revenue Code (IRC) used to prefund essential government expenses (e.g., retiree medical, and pension plan benefits). In order to remain tax-exempt, assets held in a Trust are designated as irrevocable, meaning they must be used to fund their designated use, i.e., pension for pension and OPEB for OPEB. Additionally, monies held in such trusts can be invested per Government Code 53216 (pension) and 53260 (OPEB) which allow investments to be more diversified; whereas City's investments policy is governed by the California Government Code Sections 53601.1, 53602, 53635, and 53646 which are more restrictive in nature. Furthermore, setting aside funds in a Section 115 Trust can potentially earn a higher rate of return than if funds were invested by the City on its own.

Establishing a Section 115 Trust is best practice recommended by the Government Finance Officers Association (GFOA). Some of the other benefits that a Section 115 Trust program can provide are summarized below.

- Greater expected rate of return, which helps lower liabilities
- Contributions into Trust are considered assets when performing the unfunded liability calculations which helps lowering the benefits plans liability
- GFOA recommends prefunding OPEB liabilities and considers it a best practice
- Credit rating companies look more favorable to agencies who adopt irrevocable trust and prefund Pension/OPEB obligations
- Assets are accessible for expenses (Pension for Pension and OPEB for OPEB) at any time
- Prefunding OPEB obligations has no downside other than the market fluctuations. Prefunding OPEB obligations means setting aside funds to cover future health care and other benefits for retired employees

Selection of Plan Administrator:

Since there is no cost associated with establishing a Section 115 Trust, ongoing administrative expenses are minimal and given the limited number of administrators which could provide qualified and appropriate service, staff believes that the issuance of a Request for Proposal would be inefficient and that the City staff can achieve the same outcome to obtain services for the lowest cost commensurate with quality, by directly contacting three (3) top-tier well-known firms who perform as Section 115 Trust administrators. The three firms contacted were:

- CalPERS
- PARS
- PFM Asset Management LLC (PFM)

CalPERS and PARS responded to our request; however, PFM did not show interest for two reasons: 1) they work as PARS investments advisors and 2) they are only interested in managing trusts worth more than $50 million.

Below is a summary comparison of the Trust structure between CalPERS and PARS.

	CalPERS	**PARS**
Trust Structure	2 separate trusts (Pension and OPEB)	One Combined trust
Trust Administration Fees (all inclusive)	8.5 basis points or 0.085% (1 basis point = .01%)	For Target Index-Based Strategies – 32 basis points or 0.32% For Managed Tactical Strategies – 60 basis points or 0.60%
Investment Choices	3 Strategies	4 Target Index-Based Strategies and 5 Managed Tactical Strategies
Investment Returns (as of 6/30/24)	<u>Strategy 1</u> 5-year 6.23%	<u>“Growth” Strategy</u> 5-year 8.32%
Who controls the investment selection	CalPERS Board	PARS, and US Bank (trustee w/ PFMAM as its sub-advisor)[1]
Experience	OPEB management for 17 years	40 years in administering retirement plans
Participants & Assets' worth	602 employer participants Approx. 22.3B in assets	500+ participants Approx. $8.3B in assets

1 – Public Agency Retirement Services (“PARS”) serves as the trust administrator. U.S. Bank National Association (“U.S. Bank”) serves as the discretionary trustee to the Trusts. In its capacity as discretionary trustee, U.S. Bank delegates the investment management of the Trusts to PFM Asset Management LLC (“PFMAM”) through a sub-advisory agreement. PFMAM is an investment adviser registered with the U.S. Securities and Exchange Commission (“SEC”) and an indirect subsidiary of U.S. Bank.

While PARS trust administration fees are higher than CalPERS (32 vs. 8.5 basis points), it’s crucial to focus on the most relevant metric — Net Performance (Gross Performance minus fees). As noted above, PARS outweighs the rate of return offered by CalPERS by far, making it more attractive to have the plan assets grow at a much faster pace.

Investment Strategy:

CalPERS offers three investment strategies, whereas PARS offers four Target Index-Based Strategies and five Managed Tactical Strategies. See below for more details.

CalPERS:

	CERBT Strategy 1	CERBT Strategy 2	CERBT Strategy 3
Equity %	49%	34%	23%

PARS:

PARS offers two strategies with different options available within each of them. These are listed in the tables below.

Target Index-Based Strategies				
	Growth	**Balanced**	**Conservative**	**Fixed Income**
Equity %	75%	60%	40%	0%

Managed Tactical Strategies					
	Capital Appreciation	**Balanced**	**Moderate**	**Moderately Conservative**	**Conservative**
Equity %	65-85%	50-70%	40-60%	20-40%	5-20%

With the recommendation of PARS being the Trust administrator, staff also recommends Target Index-Based "Growth" investment strategy. The following rationales were considered for choosing this strategy:

- With sufficient fund balance available in PEMHCA Fund 508 (~$6.6 million), the City may not need to withdraw funds in the shorter term to pay plan benefits and can withstand the potential volatility.
- Since this will be the first time establishing and contributing to the Section 115 Trust, there is a need for the plan assets to grow so plan benefits can be paid out of the Trust at the end of the funding strategy (i.e. strategies with amortization periods of 5, 10 or 15 years, as displayed in the table below in the "Funding Strategy" section).

Funding Strategy:

City's actuary, Precision Actuarial Inc., prepared different plan funding scenarios. These strategies were prepared based on the following assumptions:

- Total contributions of $4.5 million which represent approximately 50% of current OPEB liability of $8,980,061.
- Plan benefits will continue to be paid with the City's funds from outside the Section 115 Trust.
- Strategy I is based on CERBT Aggressive portfolio, assuming an investment rate of return of 6.25%.

- Strategy II is based on CERBT Moderate portfolio, assuming an investment rate of return of 5.84%.
- Contributions after the amortization periods are expected to be negative, meaning that if the City continues to pay benefits outside of the Section 115 Trust fund, the Trust fund will be overfunded (assuming positive fund returns) and the City should begin to pay at least some of the benefits from the trust

50% Funded		Contribution Fiscal Year														
Amort.	Strategy	2024-2025	2025-2026	2026-2027	2027-2028	2028-2029	2029-2030	2030-2031	2031-2032	2032-2033	2033-2034	2034-2035	2035-2036	2036-2037	2037-2038	2038-2039
5 Yrs	I	558,419	575,000	514,216	551,360	584,415										
	II	615,430	632,011	572,059	610,823	645,542										
10 Yrs	I	286,294	302,875	242,138	271,664	296,887	298,777	313,217	319,083	314,582	318,403					
	II	314,024	330,605	269,989	300,294	326,319	329,033	344,320	351,058	347,452	352,193					
15 Yrs	I	196,405	212,986	152,160	179,166	201,800	201,027	212,729	215,783	208,389	209,236	211,559	239,542	279,481	280,551	291,370
	II	214,263	230,844	169,299	196,785	219,912	219,646	231,870	235,459	228,617	230,030	232,935	261,517	302,071	303,773	315,242

Staff recommends 10-years funding Strategy I, which aligns with the PARS “Growth” investment strategy noted above.

California Environmental Quality Act

The approval of the Section 115 Trust is not subject to review under the California Environmental Quality Act (CEQA) pursuant to Public Resources Code Section 21000, et seq. and the CEQA Guidelines (14 Cal. Code Regs. §§ 15000 et. seq.), including without limitation, Public Resources Code section 21065 and California Code of Regulations 15378 as this is not a “project” that may cause a direct, or reasonably foreseeable indirect, physical change in the environment.

FISCAL IMPACT

With the approval of the recommended actions, the first contribution of $286,924 will be made using the reserves in PEMHCA Fund 508, which are at $6.6 million as of June 30, 2024. An appropriation of $286,924 will be needed in Account No. 508-0460-999-4155. Future contributions will be appropriated through the regular budget process.

CITY COUNCIL VISION, MISSION, AND VALUE/PRIORITY AREA

Innovation and Sustainability
Staff Empowerment and Operational Excellence

ATTACHMENTS:

Attachment 1 – City Resolution
Attachment 2 – EMID Resolution