



THE CITY OF SAN DIEGO
REPORT TO THE CITY COUNCIL

DATE ISSUED: November 8, 2007 REPORT NO: 07-189

ATTENTION: Budget and Finance Committee
Docket of Nov. 14, 2007

SUBJECT: CalPERS Retiree Benefit Trust Program

REQUESTED ACTION:

- 1) Accept the Report and recommend City Council approval to contract with CalPERS to participate in the CalPERS Retiree Benefit Trust Program (CERBT).
- 2) Authorize transfer of \$30 million in appropriated funds to the CERBT upon approval of the agreement by the CalPERS Board.

STAFF RECOMMENDATION:

Accept the Report from the Mayor and recommend City Council approval of the requested actions to participate in the CalPERS Health Trust.

SUMMARY:

The City of San Diego sponsors a retiree health benefit program and has historically funded the annual costs of the program through annual budgeted contributions (pay-as-you-go). In Fiscal Years 2007 and 2008, Council approved \$5 million and \$25 million, respectively, in the annual budgets in addition to the pay-as-you-go amounts to begin to pre-fund the accrued unfunded liability for retiree health benefits. Currently, funds totaling \$30 million reside in a special revenue fund of the City and earn the interest rate for the City's Pooled Investment Funds.

The Government Accounting Standards Board (GASB) now requires that municipalities report the net liability for retiree health on its financial statements. Cities across the state and nationally are facing the GASB reporting requirements and finding solutions to address the projected growth in the cost of retiree health care. As a result of these new reporting requirements and to find an appropriate trust fund for the City's funding of this liability, staff request that Council approve participation in CalPERS' California Employers' Retiree Benefit Trust (CERBT). This trust fund meets GASB reporting requirements, invests the City's Other Post Employment Benefit (OPEB) contributions at a longer term rate of return to achieve optimal asset growth and mitigates the City's reportable liability for retiree health.

BACKGROUND:

City of San Diego has established and maintains health benefits for eligible retirees as provided in the San Diego Municipal Code Section 24.1201 *et seq.* Retiree benefits are currently administered through the San Diego City Employers Retirement System (SDCERS) along with pension benefits. The City has historically paid for retiree health through annual budgeted contributions to pay for expected benefit costs in the current year, or pay-as-you-go. The Mayor's Five Year Outlook in 2006 identified the need to fund the accrued liability for retiree health given the fact that this component of the budget is expected to grow at an increasing rate. The pay-as-you-go portion is expected to increase from \$23 million budgeted in fiscal year 2008 to \$50 million in 2014 and possibly \$100 million in 2025. In addition, beginning with the City's fiscal year 2008 Comprehensive Annual Financial Report (CAFR), the City will have to officially calculate its OPEB liability, establish an annual required contribution (ARC) payment and either budget the ARC at its full level or record the difference as a liability on its financial statements. Based on the latest actuarial valuation as of June 30, 2006 performed by Buck Consultants, the Unfunded Accrued Actuarial Liability (UAAL) for Retiree Health is estimated to be \$1.1 billion using a 5% discount rate.

In fiscal years 2007 and 2008, \$5 million and \$25 million, respectively, has been appropriated in the City's annual budgets to begin to fund the accrued OPEB liability. In order for these funds to maximize earnings for retirees and for the City to meet GASB reporting requirements, the \$30 million in OPEB funding needs to be invested in an irrevocable trust where the assets are dedicated to pay the obligations of the City's retiree health benefit plan. Investing the assets in an irrevocable trust will allow for a higher discount rate to be applied in an actuarial valuation of retiree health: that is, a discount rate higher than the 5% used in the latest actuarial valuation as of June 30, 2006. This discount rate can be defined as the expected average return on the assets invested for a long term. A higher discount rate will not only potentially yield higher returns on the assets and grow the funds to the benefit of the beneficiaries of the retiree health plan, but will also lower the ARC payment for the City and mitigate the net retiree health obligation that will be reported on the City's financial statements. Additionally, placing the funds in an irrevocable trust is expected to have a positive effect on the credit rating analysis to be conducted by rating agencies.

Staff have investigated several options for an irrevocable trust, including the establishment of a Voluntary Employees' Beneficiary Association (VEBA). A VEBA is a 501c (9) legal entity requiring that a separate governance, administrative and investment structure be established. While this is one option that may be considered at a later date for comprehensive management of the health benefits for active and retired employees, this option will take considerable time to develop. The CalPERS trust clearly meets the investment and reporting objectives and can be implemented sooner and efficiently. No plan changes are contemplated at this time with the participation in the CERBT: the CERBT is solely an investment solution that places the appropriated City funds for prefunding the OPEB liability in an irrevocable trust where it can grow at a rate of return higher than achieved in the City's investment pool.

California Employers Retiree Benefit Trust Fund (CERBT)

The California Employers' Retiree Benefit Trust (CERBT) Fund is a new fund - a Section 115 Trust - set up for the purpose of receiving employer contributions that will pre-fund health and other post-employment benefit costs for retirees and their beneficiaries. In 2007, CalPERS established the CERBT only for contracted employers to pre-fund their OPEB obligations. In October, 2007 AB544 was signed into law allowing public sector employers not contracted with CalPERS to participate in the trust, effective January 1, 2008.

The benefits of investing with CalPERS include its 75 year experience in administering employer sponsored plans and a history of exceptional investment performance. Over the past 20 years CalPERS has averaged a 10 percent rate of return on investments. CalPERS is the largest public pension system in the U.S., managing more than \$230 billion in assets for more than 2,500 California employers. CalPERS has lower administration fees than the private sector. The administrative cost for the CERBT is estimated to be 50 basis points (.5%) applied to the invested funds, or approximately \$150,000 for a \$30 million dollar investment. CalPERS has established an investment policy for this fund adopted on December 18, 2006 that outlines the performance objective and investment approaches. This policy is included as an attachment to this report.

The CERBT accomplishes the main goals for retiree health pre-funding of the OPEB liability that staff presented to the Budget and Finance Committee in September 2007 as follows.

1) Meet GASB reporting requirements

In order to meet GASB reporting requirements, funds that have been set aside to fund the City's OPEB costs need to be placed in an irrevocable trust. The assets cannot be controlled by the City or accessed by the City's creditors and the funds must be dedicated to pay only the plan benefits to beneficiaries of the City's Retirement Health Benefit Plan.

GASB establishes standards for accounting and financial reporting but does not specify how an entity structure an OPEB plan or that the UAAL be funded. Beginning with the fiscal year 2008 financial statements, the City will need to report the net OPEB liability to the extent its actual OPEB contributions are less than its annual OPEB cost, or expense. In addition, the City will need to disclose the funded status of the plan, including the UAAL, in the financial statements.

2) Invest the assets to achieve a higher rate of return to grow retiree assets and mitigate the City's retiree health liability reported in its financial statements.

CERBT is a separate fund from the CalPERS pension fund. The discount rate that can be applied if the entire ARC is invested in CERBT each year is 7.75% or a weighted average if there is partial funding of the ARC.

The Mayor's Five Year Financial Outlook presents a funding plan for retiree health that projects payment of an estimated ARC by 2010. The ARC payment for retiree health is determined through a complex actuarial calculation, but the discount rate, or average expected rate of return, has a significant effect on the amount of the ARC payment. Higher discount rates reduce the unfunded liability and the annual ARC payment. The discount rate for the CERBT is 7.75% if

the ARC is fully contributed. If less than the ARC is invested annually, a weighted discount rate is applied that is calculated by the actuaries using the economic assumptions required by CalPERS.

For example, were the City to invest \$30 million into the CERBT in January 2008, the weighted discount rate that could be applied by the actuaries to calculate the ARC would be a blended rate between 6-7%. As the City's prefunding contributions increase, the blended discount rate would also increase to the maximum of 7.75% as established by CalPERS for this trust.

3) No plan changes at this time. The City maintains its fiduciary responsibility.

The CERBT provides a sound solution for investing retiree health assets and does not change retiree health plan benefits or plan administration. The City remains the plan sponsor and this action addresses the investment of the funds appropriated by Council to begin to pre-fund retiree health obligations. The funds will be invested to grow retiree health assets for health beneficiaries in a cost effective trust structure administered by an organization that has a proven track record for strong investment management. (Past performance does not predict future results.)

FISCAL CONSIDERATIONS:

Thirty million (\$30,000,000) in funds appropriated by City Council for funding retiree health obligations will be transferred from the City's pooled investments to the California Employer's Retiree Benefit Trust Program (CERBT) and invested according to the California Public Employees' Retirement System Statement of Investment Policy for Annuitants' Health Coverage Fund

PREVIOUS COUNCIL and/or COMMITTEE ACTION:

Presentation of Budget and Finance Committee September 12, 2007 on Health Trust Options

KEY STAKEHOLDERS AND PROJECTED IMPACTS:

Beneficiaries of the Retirement Health Benefit Plan of the City of San Diego
City Council Members as Plan Sponsors of the Retirement Health Benefit Plan

Mary Lewis
Financial Management Director

Attachments:

[California Employer's Retirement Benefit Trust Program \(CERBT\) Participation Agreement](#)

[California Public Employees' Retirement System Statement of Investment Policy for Annuitant's Healthcare Coverage Fund](#)

[Actuarial Valuation Report City of San Diego Retiree Health Benefit Program as of June 30, 2006](#)