May 15, 2018

Item Name: Senate Bill 1413 Public Employees' Retirement: Pension Prefunding

As Amended April 25, 2018

Sponsor: California Special Districts Association

Program: Legislation

Item Type: Action

Recommendation

Adopt a **SUPPORT, IF AMENDED** position on Senate Bill (SB) 1413 which would authorize the California Public Employees' Retirement System (CalPERS) to implement and administer the California Employers' Pension Prefunding Trust (CEPPT) program in order to encourage public employers to prefund their future pension contributions in an irrevocable Internal Revenue Code (IRC) Section 115 trust.

Executive Summary

SB 1413 establishes the CEPPT program to allow state and local public agency employers who provide a defined benefit (DB) pension plan to their employees to prefund their required pension contributions. It gives the CalPERS Board of Administration (Board) the authority to administer and invest the CEPPT Fund under the requirements of Section 115 of the IRC and establishes the requirements for employer participation and the conditions under which a participating employer can terminate participation or transfer funds. As currently drafted, the bill requires the Board to offer four specified investment options for funds in the CEPPT. In addition, it authorizes the Board to adopt emergency regulations and makes an appropriation of an unspecified amount for purposes of developing and implementing the CEPPT.

Strategic Plan

This proposal supports the 2017-22 CalPERS Strategic Plan goals to strengthen the long-term sustainability of the pension fund.

Background

Current Law

Current law establishes the Annuitants' Health Care Coverage Fund to prefund health care coverage for annuitants. However, there is no provision in the Public Employees' Retirement Law (PERL) for public agency employers participating in a defined benefit pension plan to prefund their payments toward their future annual required pension contributions. Current law only allows employers to provide surplus funds to CalPERS to pay down or directly offset their unfunded pension liability or unfunded actuarial accrued liability (i.e., the difference between accrued liabilities and the value of assets accumulated to finance an obligation).

IRC 115 Trust
Generally, trust income that is derived from the exercise of a governmental function, and that accrues to entities that are likewise exempt from taxation (e.g., a state or any political subdivision thereof), is excludable from gross income under Section 115(1) of the IRC. In this regard, the trust must be established only for an essential governmental function and the income earned on the trust's investments must accrue to the government entity's benefit. A Section 115 trust is generally classified as such through guidance issued by the Internal Revenue Service (e.g., revenue rulings and Treasury Regulation 301.7701-4(a)).

GASB Statement 68
The Governmental Accounting Standards Board (GASB) Statement 68 establishes standards for how employers measure and report the long-term obligations and annual costs associated with the pension benefits they provide. Specifically, the GASB Statement 68 requires a liability for pension obligations, known as the net pension liability, to be recognized on the balance sheets of the participating employers.

The California Employers' Benefit Trust
The Annuitants' Health Care Coverage Fund, sometimes referred to as the California Employers' Retiree Benefit Trust (CERBT), is a trust fund intended to meet the requirements of Section 115 of the IRC. The CERBT is dedicated to prefunding "other post-employment benefits" (OPEB), such as health, vision, dental, and life insure benefits, for eligible California public agencies, including agencies that do not contract with CalPERS for health benefits. Since its launch in 2007, more than 500 California public employers have contracted with the CERBT to prefund their OPEB obligations.

Analysis

1. <u>Proposed Changes:</u>
   Specifically, this bill:
   - Establishes the CEPPT to allow state and local public agency employers who provide a DB pension plan to their employees to prefund their required pension contributions.
   - Creates the CEPPT Fund as a special trust fund in the State Treasury and requires all monies in the CEPPT Fund be continuously appropriated to CalPERS without regard to fiscal years.
   - Provides that the Board has sole and exclusive control of the administration and investment of the CEPPT, subject to the limitations provided below.
   - Requires the Board to offer participating employers four investment options for funds in the CEPPT. Specifies that three options shall be substantially similar to the asset allocation of the three investment strategy options available for the investment of funds in the CERBT, and that the fourth option shall be substantially similar to the asset allocation of the investment portfolio of the Public Employees' Retirement Fund (PERF).
   - Requires the income earned on the CEPPT Fund to be credited to the Fund.
   - Requires each participating employer to pay an amount, not to exceed the reasonable administrative costs, as determined by the Board, for administrative and asset management of the CEPPT.
   - Requires the Board to deposit and credit the CEPPT Fund all amounts received for administrative and asset management costs.
   - Allows the Board, at its discretion and upon terms and conditions set by the Board, to authorize an employer to participate in the prefunding plan.

- Allows an employer authorized by the Board to elect to participate in the prefunding plan.
- Requires the governing body of a participating employer to enter into a contract with the Board, as specified.
- Allows the Board to terminate the participation of an employer if:
    - The employer ceases to elect to participate in the prefunding plan.
    - The Board finds the participating employer has failed to satisfy the terms and conditions required by law, board rules or regulations, or by the contract between the governing body of the participating employer and the Board.
    - The Board terminates the prefunding plan.
- Allows an employer, at the Boards' discretion, to transfer assets into or out of the prefunding plan if the transfer satisfies:
    - The terms of the contract between the governing body of that participating employer and the Board.
    - The requirements under the applicable rules of the GASB.
    - The requirements of a trust established under Section 115 of the IRC.
- Requires, if the Board terminates the participation of an employer in the prefunding plan, the assets attributable to the contributions by that employer remain in the prefunding plan, for the continued payment of required pension contributions and the costs of administration, pursuant to the terms of conditions of participation agreed to by the employer and the Board.
- Authorizes the Board to adopt regulations, including emergency regulations, to implement the CEPPT, as specified.
- Appropriates an unspecified amount from the General Fund (GF) for fiscal year 2019-2020 to develop the CEPPT.

2. <u>Prior Legislative Proposal</u>
In January 2016, CalPERS team conducted a survey of CalPERS employers to gauge interest in a pension pre-funding trust. Approximately 786 employers responded to the survey: 60 percent indicated they had not heard of a prefunding trust, 61 percent were interested in a trust, and 42 percent of respondents said they were currently pre-funding OPEB liabilities in the CERBT program.

On February 17, 2016, the team presented to the Board a legislative proposal to amend the PERL to create the CEPPT program in accordance with Section 115 of the IRC. This was met with opposition from some active member associations.

The member associations requested CalPERS include specific legislative language that would mandate employers, at a minimum, meet and confer, before entering into the trust. Employer groups spoke out in opposition to such language. The Board then directed staff to try and find a resolution between both parties. This was unsuccessful.

3. <u>CalPERS Recommended Amendments/Concerns</u>
While SB 1413 gives the Board sole and exclusive control of the administration and investment of the CEPPT Fund, it limits the Board to four investment options. Specifically, it requires three investment options of the CEPPT Fund to be similar to those available under the CERBT program for prefunding OPEB, and to one investment option that tracks the asset allocation of the PERF investment portfolio.

The prefunding strategies of the CERBT are designed to accommodate investment horizons in the medium to long term. The horizons of the CEPPT employer investors are likely to be short to medium term. Therefore, constraining the CEPPT investment strategies to mirror those of CERBT is likely to yield suboptimal performance for CEPPT contracted employers.

The CEPPT investment funds must have sufficient assets to accommodate inflows and outflows without adversely affecting investment performance. CEPPT assets are likely to be held for short to medium terms, requiring more frequent inflows and outflows than the CERBT strategies. Requiring four CEPPT investment strategies may impair the achievement of asset levels that accommodate the higher frequency of cashflows in the CEPPT.

Directing CalPERS to invest funds of the CEPPT in a particular way impinges on the Board's discretionary control to invest the funds and is inconsistent with Board's fiduciary duties. As discussed above, limiting investment options to those set forth in the bill may not be in the best interests of the participating employers. Investment options and asset allocations that the Board has determined are prudent and appropriate for the CERBT and the PERF may not necessarily be appropriate for the CEPPT.

Moreover, as a practical matter it may be difficult for CalPERS to comply with the proposed investment options currently provided for under SB 1413. For example, given that the CEPPT may not have access to private equity and real assets, the CEPPT cannot necessarily track the investment portfolio of the PERF. In addition, the bill requires that three investment options "be substantially similar" to the options available in the CERBT options. This standard may be difficult to measure over time and may be subject to multiple interpretations. Therefore, staff recommends the author amend the bill to remove the provision prescribing the four investment options.

Budget and Fiscal Impacts

1. <u>Benefit Program Costs</u>
   Participation in the CEPPT would be voluntary, and costs for administering the program would be paid by participating agencies.

2. <u>Administrative Costs</u>
   Program implementation is dependent upon legislative approval and a GF appropriation in FY 2019-2020. Staff estimates the start-up costs for the CEPPT to be $695,140 which includes system setup, legal support, Northeast Retirement Services, Inc. (NRS) Account Recordkeeping, and five full-time positions for the first fiscal year. Information technology function or support would be minimal as the CEPPT would work outside of the my|CalPERS system. The CEPPT program would use the PeopleSoft Financial system.

Benefits and Risks

<u>Benefits:</u>

- According to the author, this bill will "help public agencies throughout California manage their pension obligations by allowing for payments into a CalPERS-managed prefunding trust."
- Amount of contributions to the fund, from both a funding and timing perspective, are controlled by the employer and are voluntary.
- Promotes fiscal responsibility and accountability for employers to deal with long term pension liabilities.

Risks:

- Not enough interest to support the program.
- Employers may decrease CERBT contributions in order to prefund in the CEPPT.
- Requires a GF appropriation to establish and implement the trust.

Attachments

Attachment 1 – Legislative History
Attachment 2 – Support and Opposition

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