CalPERS

Finance & Administration Committee

California Public Employees' Retirement System

Agenda Item 6a

February 17, 2016

ITEM NAME: Proposed California Employers' Pension Prefunding Trust (CEPPT) Legislation

PROGRAM: Legislation

ITEM TYPE: Action

RECOMMENDATION

Sponsor legislation to allow the implementation of the California Employers' Pension Prefunding Trust (CEPPT) Program to be administered by the California Public Employees' Retirement System (CalPERS), while continuing to work with stakeholders on the specific language for the proposed legislation.

EXECUTIVE SUMMARY

Staff seeks approval of a legislative proposal to amend the Public Employees' Retirement Law (PERL) to create the CEPPT in accordance with Section 115 of the Internal Revenue Code (IRC). The CEPPT would provide an important trust fund through which eligible California public agency employers may prefund their future annual pension contributions and an additional option for employers to pay down their unfunded liability to a defined benefit plan.

STRATEGIC PLAN

This agenda item supports the CalPERS Strategic Plan Goal A to improve long-term pension and health benefit sustainability.

BACKGROUND

Generally, income of a trust 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 (IRS) (e.g., revenue rulings and Treasury Regulation 301.7701-4(a)).

Under the PERL, no provision exists for public agency employers participating in a defined benefit pension plan to prefund their payments toward their future annual required pension contributions. Instead, current law only allows employers to apply surplus funds 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).

Recently, we understand that private sector providers have developed a Section 115 Irrevocable Trust (Trust) for public agencies to prefund their pension costs and help reduce their Governmental Accounting Standards Board (GASB) 68 Net Pension Liabilities. The Trust appears to be similar to CalPERS' California Employers' Retiree Benefit Trust (CERBT). However, the CERBT is currently limited to prefunding employers' OPEB liabilities, not pensions.

Current market trends and the recent changes to the GASB Statement 68 Accounting and Financial Reporting for Pensions have resulted in a demand among our public agency employer community for the creation of a Trust for pre-funding pension costs.

ANALYSIS

California's public agencies and local governments currently have the ability to set aside funds outside of CalPERS to prefund and manage future pension costs. Assets are invested in a trust for the sole purpose of paying future required pension contributions or paying additional contributions toward an agency's unfunded pension liability.

For example, the Public Agency Retirement Services (PARS) offers a Section 115 irrevocable trust designed for agencies to pre-fund pension costs and reduce unfunded liabilities. Based on staff analysis, we estimate that as many as 50 CalPERS contracted employers participate in the PARS trust.

By proposing legislation to allow eligible public agency employers to prefund their future pension contributions in an irrevocable IRC Section 115 trust, CalPERS would continue to be responsive to the public employer community's needs and demands for providing pre-funding pension obligations.

A Section 115 trust would provide employers with an investment vehicle that will give them the ability to manage their payments toward their ARC. Additionally, recent changes to GASB Statement 68 effective for employer fiscal years beginning after June 15, 2014, significantly changes how employers measure and report the long-term obligations and annual costs associated with the pension benefits they provide. Specifically, the new GASB Statement 68 requires a liability for pension obligations, known as the net pension liability (NPL), to be recognized on the balance sheets of the participating employers. Under GASB Statement 68 reporting criteria, employers cannot offset their pension liabilities with assets over which they retain discretionary control and could potentially redirect for other purposes. However, an irrevocable IRC Section 115 trust established for the sole purpose of prefunding employer pension contributions would provide employers a mechanism and ability to reduce their pension liabilities for reporting purposes under GASB Statement 68.

As part of the risk mitigation work that the CalPERS board and staff have engaged in with stakeholders over the last 18 months, additional employer contributions towards employers' unfunded liability have been encouraged as an effective way to increase the funded status.

Stakeholder Outreach
In January, staff conducted a survey of CalPERS employers to gauge their interest in participating in a pension pre-funding trust and to understand what program structures and investment risk and return profile would work best for them.

Approximately 786 employers responded to the survey. Below are highlights of the results:

- 60% of respondents indicated they have not heard of a prefunding trust, providing staff with an opportunity for education
- 61% would be interested in a pension pre-funding trust program
- When asked about risk and return profiles, 47% said "low risk," 28% said "very low risk" and 25% said "moderate risk"
- 42% of respondents are currently pre-funding OPEB liabilities

Staff has also conducted preliminary discussions with member and employer association leaders and will continue to gather their feedback and input on the interest level of CalPERS establishing a pension pre-funding trust program.

Member association leaders have requested that language be included in the proposed legislation that would require "mutual agreement" between the employer and employee groups before the employer could contribute funds to the pension pre-funding trust. Leaders believe mutual agreement is necessary to ensure that employers do not bargain to impasse and unilaterally implement a contribution to the trust over the objections of employee organizations. While the member association leaders have indicated they support the concept of prefunding pension obligations with surplus funds, a concern related to how "surplus funds" are determined, allowing employers to divert funds into a trust account that cannot be accessed for purposes other than pension obligations and doing this without first negotiating with the exclusive representative of public employees. Without such language, member associations have indicated that they could not support the creation of the trust.

Employer association leaders representing our employers believe a pension pre-funding trust would benefit employers, however, some feel the language proposed by member associations may be an impediment to employers participating in the trust. Leaders believe that the process of funding pensions is already transparent and part of the current budget process for employers. Early indications from employer associations indicate that such language may undermine the program's intent and make pre-funding substantially less attractive and feasible to cities.

CalPERS staff will continue to discuss considerations with both parties to meet the needs of our members and employers. If staff are unable to reach a conclusion that is satisfactory, we will return to the Committee in March for further discussion.

BUDGET AND FISCAL IMPACTS
Program implementation is dependent upon legislative approval and an appropriation to create the new program with the earliest implementation date of January 2017.

BENEFITS/RISKS

Benefits associated with the establishment of an irrevocable IRC Section 115 trust for purposes of prefunding future pension payments include the following:

- Contributions to the fund, from both a funding and timing perspective, are controlled by the employer and are voluntary.
- This program offering increases the options available to employers with surplus funds that wish to manage their payments toward their ARC.
- Promotes fiscal responsibility and accountability for employers to deal with long-term pension liabilities.
- Recent GASB reporting standards allow for an irrevocable trust for the sole purpose of paying employer retirement contributions to be reported as an offset to their total pension liability (“TPL”) on the employer’s financial statements.
- Establishes an alternative investment mechanism with additional investment choices.
- Provides the ability for employers to have greater investment flexibility and risk diversification compared to an employer’s general investments.
- Provides effective cost management for participating employers.

Risks associated with the establishment of an irrevocable IRC Section 115 Trust for purposes of prefunding pension payments include the following:

- Requires legislative approval and appropriation to establish and implement the trust.
- Lack of interest by employers or only a small number of employers that have surplus funds to invest.
- Without the benefit of the trust accumulating assets, the administrative costs may outweigh any potential benefits.

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