

CITY OF SANTA ROSA  
CITY COUNCIL

TO: MAYOR AND CITY COUNCIL  
FROM: ALAN ALTON, CHIEF FINANCIAL OFFICER  
SUBJECT: APPROVAL OF INVESTMENT POLICY STATEMENT FOR  
PEMHCA SECTION 115 TRUST AND APPROPRIATION OF  
INITIAL FUNDING FROM OPEB FUND

AGENDA ACTION: RESOLUTION

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RECOMMENDATION

It is recommended by the Finance Department that the Council, by resolution: 1) approve the Investment Policy Statement for City of Santa Rosa Section 115 Trust Public Employees Medical and Hospital Care Act (PEMHCA) Other Post Employment Benefit (OPEB) Fund as set forth in Exhibit A; (2) authorize the Chief Financial Officer to execute necessary documents for the creation of the Internal Revenue Service Section 115 Trust (Trust); and 3) authorize an initial one time deposit of \$12,281,000 from the Trust and increase appropriations in the OPEB Fund for fiscal year 2023/24 accordingly for the purpose of pre-funding PEMHCA OPEB expenses.

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EXECUTIVE SUMMARY

The City of Santa Rosa currently provides a post-employment medical health benefit to public safety employees in accordance with the Public Employees Medical and Hospital Care Act (PEMHCA). PEMHCA requires that agencies contracted with CalPERS health plans contribute towards retiree health premiums for enrolled retired members. CalPERS health plans are not open to Santa Rosa's miscellaneous employees making them ineligible for this benefit. The City contributes the minimum amount as prescribed by PEMHCA, adjusted annually for inflation. The benefit amount for 2024 is \$157 per month per enrolled retiree. Employee benefits provided by the City are agreed upon contractually with our employee bargaining units. This benefit is administered by CalPERS and the City remits monthly premiums to pay for our enrolled retirees. CalPERS uses a "pay as you go" method wherein the City pays for benefits currently being provided, versus a prefunding methodology like the City's pension retirement costs. This "pay as you go" methodology has resulted in a significant unfunded actuarial liability (UAL) of \$24,964,000 recorded on the City's financial statements as of 6/30/2023.

The strategy recommended to address this PEMHCA UAL is to establish a Trust, which is an actively managed fund, outside the City's investment portfolio, that may be used

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only to pay these OPEB obligations. The City would use this Trust to prepay for this expense resulting in a reduction to the current UAL associated with its PEMHCA OPEB obligation. By placing funds in the Trust, we will receive more accurate actuary reporting because the current funding within the City's OPEB Fund cannot be used to offset UAL, while funds placed in the Trust can. Improved reporting will provide the City planning options to fully address PEMHCA UAL. The Trust provides an opportunity for better long-term investment returns, versus the City's treasury portfolio, through broader investments, focused on better long-term returns.

Staff proposes that an initial deposit be made into a Trust of \$12,281,000 from an existing OPEB Internal Service Fund (OPEB Fund). Starting in 2011, the City began to budget funding for the OPEB Fund to offset this liability and the balance is expected to be \$12,281,000 by 6/30/24. Annual contributions to the Trust will begin with the upcoming budget in the same manner and amount that was used to fund the OPEB Fund.

The City's strategy relative to the Trust is to use it as a long-term investment vehicle to address the City's PEMHCA UAL. The funding goal will be driven by the annual actuary report with a strategy to become 100% funded over time. This will provide consistency and savings for the General Fund.

The addition of a separate account for the PEMHCA Trust does not require a new agreement; the City's existing Trust Agreement with PFM Asset Management LLC (PFMAM) facilitates separate accounts and reporting to separate the PEMHCA Trust from our existing General Fund and Water Fund Pension 115 Trusts created in May of 2022.

## BACKGROUND

The City currently has a Section 115 trust to pre-fund pension expenses with PFM Asset Management LLC (PFMAM) serving as Trust Administrator, and Principal Bank serving as Trustee. The City will utilize this existing agreement for the PEMHCA Trust, with a new account being created to ensure these funds are separately reported and dedicated to PEMHCA pre-funding and claims payment. The existing agreement for Trust Administrative Services from PFMAM is included as Attachment 1.

Section 115 of the Internal Revenue Code allows for pre-funding pension and OPEB obligations with a trust. The funds invested in the Trust are separate from those in the City's investment portfolio and are not held to the same investment restrictions that govern general local government investing. In other words, the funds in the Trust may be invested more broadly with a strategy for higher long-term returns.

Utilizing this type of Trust has its advantages and risks. The potential advantages include local control over the asset strategy and timing of usage; ability to earn higher returns; and bond rating agencies will look favorably to this type of action.

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The potential risks include market changes resulting in the loss of principal, and that the funds held in Trust may be used only for PEMHCA obligations.

It should be noted that the City has a long history of using Section 115 Trusts. Around 2005, the City asked for and received a ruling from the Internal Revenue Service to establish Section 115 Trusts for the various retiree medical stipend accounts that benefit members of many of the City's employee groups. These Trusts are still active and performing well, and under the management of PFMAM.

PRIOR CITY COUNCIL REVIEW

None.

ANALYSIS

The entirety of the PEMHCA UAL of \$24,964,000 lies with the General Fund and without addressing via PEMHCA Trust we expect the "pay as you go" expenses to grow exponentially. The funds for the PEMHCA Trust will be separate from the existing pension accounts.

Ongoing funding to the Trust will come from existing budgets for this expense currently within Police and Fire Department budgets. No other departments currently budget for this expense as it only benefits public safety employees. No additional funding is being proposed beyond the existing funding already being directed to the OPEB Fund for the upcoming budget. Funding in future years will be guided by the City's actuary reporting for the Trust with the long-term goal of being fully funded. A fully funded PEMHCA Trust is an attainable goal for the City and would have a large cost savings.

**Investment Policy.** The investment objectives for the Trust are based on a long-term investment horizon of 10 years or longer, and the targeted rate of return is between 5% and 6%. As such, assets will be invested in classes targeting 50% of domestic and international equities, and 50% fixed income. The Trust will be actively managed, and the Trust's advisor will be permitted under the Policy to rebalance the assets based on market conditions. Also, the Trust will be managed in a manner to minimize principal fluctuations over the ten-plus year investment horizon.

The purpose of the Investment Policy statement is to document the investment strategy, performance expectations and investment guidelines for the Fund. The statement establishes the strategy for managing Fund assets, establish investment guidelines to control risk and liquidity, and establish periodic performance reporting requirements. Finally, they ensure compliance with fiduciary obligations, prudence, due diligence, and legal requirements for the Fund assets.

**Funding Strategy.** The City's goal is for PEMHCA UAL to be fully funded over time. Once the Trust is established our actuary will be able to provide reporting on a strategy to attain full funding.

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Staff proposes to fund the trust with an initial deposit, followed by ongoing annual contributions which are existing annual budgeted expenses already going to the OPEB Fund. An initial deposit of \$12,281,000 would come from the OPEB Fund.

**Fees.** Fees for the Trust are based upon funds held in trust, in the aggregate. The approximate annual fee is .0023%, so the fees for the new investment deposits of \$12,281,000 million will be approximately \$2,825. These fees are paid out of the Trust's assets. In addition, annual Trustee/Custodial fees established by Principal Bank are estimated at \$9,000. These fees will reduce the principal of the trust account each year but are factored into our expected investment earnings and do not materially impact the Trust. These fees are not paid from General Fund budgets, and we expect a long-term rate of return of the fund to be 5% to 6% which will more than cover these costs.

#### FISCAL IMPACT

There is no current budgetary impact to the General Fund resulting from this item. The City will use \$12,281,000 of fund balance in the OPEB Fund. Future expense increases are expected from PEMHCA, and the City is contractually obligated to pay them. Establishment of a 115 Trust will mitigate future increases through higher investment earnings coming from a more strategic and broad investment policy than the greater treasury portfolio of the City. The annual funding strategy being proposed is budget neutral by redirecting funds already allocated for this expense from the OPEB Internal Service Fund to the Trust.

#### ENVIRONMENTAL IMPACT

The actions provided for herein are exempt from the provisions of the California Environmental Quality Act (CEQA) under CEQA Guidelines Section 15061(b)(3) and 15378 in that there is no possibility that the implementation of these actions may have significant effect on the environment. No environmental review is required.

#### BOARD/COMMISSION/COMMITTEE REVIEW AND RECOMMENDATIONS

On November 9, 2023, Finance presented an overview of a PEMHCA Trust option to the Long-Term Financial Policy and Audit Subcommittee (LTFPA) to receive direction. The Committee recommended staff develop an Investment Policy Statement and bring to City Council a Report Item for consideration.

#### NOTIFICATION

Not applicable.

#### ATTACHMENTS

- Attachment 1 - Trust Administrative Services Agreement (PFMAM)

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- Resolution / Exhibit A –Investment Policy Statement (PEMHCA Other Post-Employment Benefit (“OPEB”) Fund)

PRESENTER

Scott Wagner, Deputy Director