

CITY OF SANTA ROSA  
CITY COUNCIL

TO: MAYOR AND CITY COUNCIL  
FROM: ALAN ALTON, CHIEF FINANCIAL OFFICER,  
FINANCE DEPARTMENT  
SUBJECT: RESOLUTION – APPROVAL OF SECTION 115 TRUST  
AGREEMENTS AND APPROPRIATION OF INITIAL FUNDING

AGENDA ACTION: RESOLUTION

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RECOMMENDATION

It is recommended by the Finance Department that the Council, by resolution: 1) approve the execution of the Adoption Agreement for the Post-Employment Benefits Trust (Adoption Agreement) between the City and PFM Asset Management LLC (PFMAM) incorporating and adopting the Trust Agreement as well as approving the Trust Administrative Services Agreement and Investment Policy Statements included as exhibits to the Adoption Agreement; 2) authorize the City Manager, Assistant City Manager and the Chief Financial Officer as officers with authority to execute necessary documents and agreements to carry out the trust services on behalf of the City including, but not limited to the Adoption Agreement and Trust Administrative Services Agreement; and 3) approve an initial deposit of \$10,000,000 from the General Fund reserves assigned for fiscal stability, and \$4,400,000 from Santa Rosa Water enterprise fund reserves to the Section 115 Trust for the purpose of pre-funding pension obligations.

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EXECUTIVE SUMMARY

In September 2021, the staff presented pension funding strategies to the City Council at a study session. One such strategy is to establish an Internal Revenue Code Section 115 Trust (Trust), which is an actively managed fund, outside the City's investment portfolio, that may only be used to pay pension obligations. The City would use this Trust initially to reduce the current unfunded accrued liability (UAL) associated with its CalPERS pensions.

Staff proposes an initial deposit to the Trust of \$10,000,000 from the fiscal stability funds assigned in the General Fund reserves, and \$4,400,000 from Santa Rosa Water (SRW) enterprise funds reserves to pre-fund pension obligations. Annual contributions to the Trust from the General Fund and SRW will begin after the City's existing Pension Obligation Bonds are paid off in 2024. By redirecting budget the debt service payments

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to Trust contributions, the City will benefit from annual contributions to build up Trust balances without increasing the budget.

The City's strategy relative to the Trust is to use it as a long-term investment vehicle to address the City's CalPERS UAL. The initial funding goal will be to accumulate a balance in the trust equal to the General Fund's highest scheduled annual UAL payment; then to use the Trust in combination with CalPERS valuation reports to achieve 100% funded status; and finally to utilize the Trust as a pension stabilization fund by using the accumulated funds to offset future higher-than-usual normal cost or UAL payments.

### BACKGROUND

Pursuant to the City's Purchasing Policy (Section 3-08 of the Santa Rosa City Code), staff requested proposals for trust administration services. Staff received proposals from Public Agency Retirement Services (PARS) and PFM Asset Management LLC (PFMAM), and had follow-up interviews with both firms. While both firms are well known in the industry and provide quality services, the City selected PFMAM based on how they presented their strategic approach to helping the City achieve its pension stabilization goals. PFMAM will serve as the Trust Administrator, and Principal Bank will serve as the Successor Trustee. The proposal for Trust Administrative Services from PFMAM is included as Attachment 1.

Section 115 of the Internal Revenue Code allows for pre-funding pension 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.

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

It should be noted that the City has a 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 which 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

Staff held a study session on December 7, 2021, to discuss Fiscal Policies, which included the potential benefits of a Section 115 Trust.

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ANALYSIS

The majority of the City's pension obligation is in the General Fund and the SRW enterprise funds. Finance and SRW staff have met with PFM to discuss Trust strategies, including risk tolerance and asset allocation, and also confirmed the City can open a separate account within the Trust for SRW funds. This will ensure Santa Rosa Water funds are held separate from City general funds.

**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.

Incorporated with the Adoption Agreement is an Investment Policy Statement for the City Pension Fund and the Santa Rosa Water Pension Fund. The purpose of these Policy statements is to document the investment strategy, performance expectations and investment guidelines for the Funds. The statements establish 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 the General Fund to reach \$34,000,000 in the Trust. This represents the highest scheduled annual UAL payment PLUS the normal employer cost (total annual payment to PERS). The corresponding amount for SRW would be \$7,500,000.

Staff proposes to fund the trust with an initial deposit, followed by ongoing annual contributions. An initial deposit of \$10,000,000 would come from the \$40,000,000 of "fiscal stability" funds assigned in the General Fund, and SRW will make an initial deposit of \$4,400,000 from its undesignated reserves.

Ongoing contributions to the fund will begin after the City's existing Pension Allocation Bonds (POB) have been paid off in 2024. The total annual debt service is approximately \$3,700,000, with \$2,600,000 coming from the General Fund, and \$700,000 from SRW. With an established budget line item for the debt service, continuing that budget line item for Trust contributions would result in considerable annual contributions to the trust with no additional cost to the General Fund or SRW budgets.

The goals for the General Fund and SRW of achieving \$34,000,000 and \$7,500,000 in the Trust may be accomplished in approximately 10 years, depending upon market returns.

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**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 \$14,400,000 million will be approximately \$33,000. 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.

FISCAL IMPACT

There is no ongoing budgetary impact to the General Fund as a result of this item. The City will use \$10,000,000 of the \$40,000,000 of fiscal stabilization funds assigned in the General Fund for the initial deposit. SRW will make an initial deposit of \$4,400,000, with \$3,500,000 from Water (Fund 1611) reserves, and \$900,000 from Local Wastewater (Fund 1621) reserves.

Annual contributions will begin after the City's existing Pension Obligation Bonds (POB) are paid off in 2024. Beginning in FY 2024/25, the \$2.6 million budget for the General Fund POB debt service will be redirected as an annual contribution to the Trust. In addition, beginning in FY 2024-25, the \$700,000 budgeted by SRW to fund their portion of the POB debt service will be redirected to contribute to their portion of the Trust.

The fees for managing the Trust are based on total assets held in aggregate and will be paid for out of the assets held in 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 further environmental review is required.

BOARD/COMMISSION/COMMITTEE REVIEW AND RECOMMENDATIONS

Staff presented "Fiscal Strategies" including the uses of a Section 115 Trust at the November 18, 2021, and March 8, 2022, meetings of the Long-Term Financial Policy and Audit Subcommittee.

Staff presented information on Santa Rosa Water's Section 115 Trust at the April 7, 2022 and April 21, 2022 Board of Public Utilities meetings.

NOTIFICATION

Not applicable.

ATTACHMENTS

- Attachment 1 - Proposal For Trust Administrative Services (PFMAM)

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- Resolution / Exhibit A – Adoption Agreement for the Post-Employment Benefits Trust which includes as Exhibits: Trust Administrative Services Agreement; Investment Policy Statement (City Pension Fund); and Investment Policy Statement (Santa Rosa Water Pension Fund)

CONTACT

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