Agenda Date: 6/16/2021, **Item No.** 38

Authorization to Adopt Proposed Update to Pension Plans Funding Policy (Ordinance S-47723)

Request to adopt a Pension Funding Policy applicable to City of Phoenix Employee Retirement System (COPERS) and Public Safety Personnel Retirement System (PSPRS). A Pension Funding Policy to clearly communicate the City's funding objectives is a requirement adopted by the State Legislature in 2018 as A.R.S. 38-863.01 **(Attachment A)** to be implemented on an annual basis by June 30. While the State law only applies to PSPRS, for the third year in a row City staff recommends also adopting a COPERS funding policy as a transparent sound financial practice. This report further requests the Council to adopt a policy for the utilization of recreational marijuana revenues and a policy on the issuance of Pension Obligation Bonds.

Summary

The State law requires the City to:

1) Annually adopt a Pension Funding Policy.

2) Formally accept the Employer's share of the assets and liabilities under each pension system based on the actuarial valuation report.

3) Post the Policy on the City's website.

For review and discussion purposes, a proposed Pension Funding Policy for both PSPRS and COPERS can be found in **Attachments B and C.** A final City Pension Funding Policy must be adopted and posted on the City's website by July 1 each year.

Over the last several years the Phoenix City Council and voters have taken responsible actions to ensure the pension plans are financially stable while maintaining services to the public. Increase in net pension liabilities **(Attachment D)** and annual costs **(Attachment E)** have placed significant budgetary constraints on the City’s ability to provide employee wage and non-pension benefit increases, public services and infrastructure maintenance. While currently manageable, this pressure will continue into the foreseeable future. Further, credit rating agencies and lenders place strong consideration on the funding plan and funding levels of the City’s pension systems when determining their view of the overall financial health of the City.

The Phoenix City Council has requested staff provide various pension funding options, which has resulted in the following actions:

1) Maintained our legal commitment to employees and retirees to pay at least 100% of the actuarially required contribution (ARC) to each plan.

2) Adopted a balanced budget based on a 25-year amortization schedule for PSPRS, which is more aggressive than the 30-year amortization adopted through State Law. However, the 25-year amortization schedule allow budgetary capacity to continue providing quality services and fair compensation for employees.

3) Established a Pension Reserve Fund to stabilize annual PSPRS payments.

4) Advanced $70 million in Wastewater enterprise funds to pay down the COPERS liability in FY18.

5) Ongoing coordination with the Aviation Department for advance paydowns of $100 million and $70 million in FY21 and FY22, respectively.

These actions are in addition to the COPERS pension reform that the City Council and voters have implemented since 2013 and the statewide PSPRS pension reform passed by the voters in 2016. These actions have resulted in savings of more than $1 billion over 25 years for the City.

<u>Results to Date</u>
Implementation of the City Council's direction has resulted in improvements to the funded position and stabilization of the plans, including an increase in the funded ratio for COPERS to 60.74 percent for fiscal year ending 2020, up from 60.43 percent in fiscal year ending 2019 **(Attachment F)**. The funded ratio for PSPRS was 39.81 percent for fiscal year ending 2020 and was 40.24 percent for fiscal year 2019 **(Attachment F)**. However, the City's total Net Pension Liability increased to $5.4 billion. This is an indication that ongoing attention to the funded position of the plans and strategies to increase payments over a sustained period is necessary in conjunction with balancing the current needs of the community and employees.

<u>Future Considerations</u>
In accordance with State law, the City Council must formally accept the assets,

liabilities, and current funding ratio of the City's pension funds as stated in the annual actuarial valuations for the City of Phoenix **(Attachments G and H)** and must approve funding goals **(Attachments B and C)** by July 1, 2021.

While the pension systems are not currently fully funded, the strategy to pay the ARC and pay down the liability over a set period (20 years remaining for PSPRS and 18 years remaining for COPERS) allows flexibility in proving services to the public while spreading the liability to our residents over a period of time.

Under current actuarial calculations and amortization periods, PSPRS will be 100% funded by June 30, 2042 **(Attachment I)** and COPERS will be 100% funded by June 30, 2039 **(Attachment I)**. Under the leadership of the City Council, the City can continue to take steps to ensure the current actuarial determined funding expectations are achieved on this schedule, or even reach 100% funded within a shorter timeframe.

Next steps to address the City's pension liability could include:

1) Continuing to balance the budget and pay the annual contribution required by actuaries.

2) Using any excess cash, including any savings from the refinancing of long-term debt obligations, to fund the pension reserve fund or directly pay down the liability.

3) Allocating budgetary resources of revenues from recreational (non-medical) marijuana sales to directly pay down the liability for PSPRS through accelerated pension payments.

4) Seeking opportunities to advance payments from enterprise and/or special revenue funds.

5) Continue evaluating the feasibility of funding the pensions through Pension Obligation Bonds under the proposed policy if established by the City Council.

6) Reviewing investment rate or returns on pension assets, actuary assumptions and to forecast future annual required contributions.

7) Compiling sensitivity and scenario analyses on proposed changes to the pension plans.

Recreational (non-medical) Marijuana Revenues
In November 2020 voters approved Proposition 207 legalizing the sale of recreational marijuana in the State of Arizona. This proposition also created a new fund for the revenues collected from the sale of recreational marijuana which will be distributed through several allocation streams.

The City of Phoenix will receive recreational marijuana revenues from four sources, including:

1) City of Phoenix regular general fund sales tax.
2) Public Safety proportional allocation based on PSPRS membership.
3) HURF proportional allocation.
4) State-shared sales tax revenue.

Staff recommends the City Council adopt a policy to annually direct revenues from 1 and 2 above (the City's sales tax of recreational marijuana and the City's Public Safety allocation) to paying down PSPRS pension liability. Staff estimates applying the additional revenues to PSPRS would result in reaching 100% funded a year earlier than projected without doing so.

Pension Obligation Bonds (POBs)
Pension Obligation Bonds are bonds issued to pay pension plan liabilities. The City Council previously directed staff to study and evaluate the possibility of issuing Pension Obligation Bonds. With City Council's direction, staff research and determined a set of conditions required for issuing Pension Obligation Bonds.

Staff recommends the City Council adopt a policy for issuing Pension Obligations Bonds only if the following conditions exist:

1) Bond Interest rates are under 3.5 percent.
2) The City applies all savings from issuing POBs to PSPRS for the unfunded liability.
3) Rating indications are neutral.

Furthermore, additional City Council authorization would be required for issuance of Pension Obligation Bonds. Staff estimates issuing Pension Obligations Bonds would result in PSPRS reaching 100% three years earlier.

Responsible Department
This item is submitted by City Manager Ed Zuercher and Chief Financial Officer Denise Olson.

Attachment B
City of Phoenix
Public Safety Personnel Retirement System
Pension Funding Policy

The intent of this policy is to clearly communicate the Council's pension funding objectives and its commitment to our employees and the sound financial management of the City and to comply with statutory requirements of Laws 2018, Chapter 112.

Several terms are used throughout this policy:

Unfunded Actuarial Accrued Liability (UAAL) – Is the difference between trust assets and the estimated future cost of pensions earned by employees. This UAAL results from actual results (interest earnings, member mortality, disability rates, etc.) being different from the assumptions used in previous actuarial valuations.

Annual Required Contribution (ARC) – Is the annual amount required to pay into the pension funds, as determined through annual actuarial valuations. It is comprised of two primary components: normal pension cost – which is the estimated cost of pension benefits earned by employees in the current year; and, amortization of UAAL – which is the cost needed to cover the unfunded portion of pensions earned by employees in previous years. The UAAL is collected over a period of time referred to as the amortization period. The ARC is a percentage of the current payroll.

Funded Ratio – Is a ratio of fund assets to actuarial accrued liability. The higher the ratio the better funded the pension is with 100% being fully funded.

The City's police and fire employees who are regularly assigned hazardous duty participate in the Public Safety Personnel Retirement System (PSPRS).

Public Safety Personnel Retirement System (PSPRS)

PSPRS is administered as an agent multiple-employer pension plan. An agent multiple-employer plan has two main functions: 1) to comingle assets of all plans under its administration, thus achieving economy of scale for more cost-efficient investments and invest those assets for the benefit of all members under its administration and 2) serve as the statewide uniform administrator for the distribution of benefits.

Under an agent multiple-employer plan each agency participating in the plan has an individual trust fund reflecting that agencies' assets and liabilities. Under this plan all contributions are deposited to and distributions are made from that fund's assets, each fund has its own funded ratio and contribution rate, and each fund has a unique annual actuarial valuation. The City of Phoenix has two trust funds, one for police employees and one for fire employees.

Council formally accepts the assets, liabilities, and current funding ratio of the City's PSPRS trust funds from the June 30, 2020 actuarial valuation, which are detailed below.

Trust Fund	Assets	Accrued Liability	Unfunded Actuarial Accrued Liability	Funded Ratio
Phoenix Police	1,368,290,122	3,492,835,270	2,124,545,148	39.17%
Phoenix Fire	765,370,023	1,867,271,442	1,101,901,419	40.99%
City of Phoenix Totals	2,133,660,145	5,360,106,712	3,226,446,567	39.81%

For comparative purposes, the City of Phoenix total Unfunded Actuarial Accrued Liability for the prior fiscal year ending June 30, 2019 was $3.03 billion and the funded ratio was 40.34%.

PSPRS Funding Goal

Fully funded pension plans are the best way to achieve taxpayer equity. However, most funds in PSPRS are significantly underfunded due to historical low returns on plan assets, people in general living longer and decreases in governmental workforces. As shown above, the UAAL for the City is $3.2 billion which should be paid over time to avoid a huge burden to current taxpayers by either significantly decreasing services or an increase in taxes. This taxpayer burden must be balanced with being fiscally responsible and committed in providing pensions to retirees.

The Council's PSPRS funding ratio goal is 100% (fully funded) by June 30, 2042.

Council has taken the following actions to achieve the June 30, 2042 goal:

- Maintain ARC payment from operating revenues – Council is committed to maintaining the full ARC payment (normal cost and UAAL amortization) from operating funds.
- Additional payments above the ARC
    - City Council has approved paying the ARC based on a 20-year remaining amortization schedule. The budget for the ARC for FY 21 is $283.6 million, which is $39.7 million more than the actuarial amount.
    - Established the Pension Reserve Fund to ensure annual payment during downturns in the economy. Currently, there is $41 million in the reserve fund.

To achieve this goal, the City may utilize the following strategies:

1. Maintaining the City's legal commitment to employees and retirees by paying at least 100% of the annual required contribution.
2. Evaluating prior year budget compared to actual expenditures and make an excess payment to either the Pension Reserve Fund or directly to PSPRS to accelerate pension payments to directly pay down the liability
3. Allocating budgetary resources of revenues from recreational (non-medical) marijuana sales to directly pay down the PSPRS liability through accelerated pension payments. Specific marijuana categories would only include direct revenues from the City's general fund sales tax of recreational marijuana and the City's Public Safety allocation to paying down PSRPS pension liability.

4. Authorizing City staff to develop a financing plan issuing Pension Obligation Bonds if bond interest rates are under 3.5 percent, the City applies all savings from issuing POBs to PSPRS and rating indications from rating agencies are neutral.
5. Reviewing investment rate of returns on pension assets, actuary assumptions and to forecast future annual required contributions.
6. Compiling sensitivity and scenario analyses on proposed changes to the pension plan.