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Agenda Date: 6/14/2023, Item No. 53

Authorization to Adopt Proposed Update to Pension Funding Policies (Ordinance S-49826)

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 Arizona Revised Statutes Section 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 fifth year in a row City staff recommends also adopting a Pension Funding Policy for COPERS as a transparent sound financial practice.

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

For review and discussion purposes, a proposed Pension Funding Policy for both COPERS and PSPRS 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 systems are financially stable while maintaining services to the public. Fluctuations in unfunded 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. 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 still allows budgetary capacity to continue providing quality services and fair compensation for employees.
2. Established a Pension Reserve Fund to stabilize annual PSPRS payments.
3. Advanced \$70 million in Wastewater enterprise funds to pay down the COPERS liability in Fiscal Year 2017-18. Advanced \$170 million in Aviation enterprise funds to pay down the COPERS liability in Fiscal Year 2020-21.
4. Authorized a portion of recreational (non-medical) marijuana tax revenue to directly pay down the PSPRS pension liability.

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.

Results to Date

Implementation of the City Council's direction has resulted in improvements to the funded position and stabilization of COPERS, including the current funded ratio for COPERS to 68.65 percent for fiscal year ending 2022, down from 75.70 percent in fiscal year ending 2021 (**Attachment F**).

The funded ratio for PSPRS was 42.44 and 45.20 percent for Police and Fire, respectively, for fiscal year ending 2022 and was 37.22 and 38.05 percent for Police and Fire, respectively, for fiscal year ending 2021 (**Attachment F**). This is an indication that ongoing attention to the funded position of PSPRS and strategies to increase payments over a sustained period is necessary in conjunction with balancing the current needs of the community and employees.

In November 2020, voters approved Proposition 207 legalizing the sale of recreational marijuana in the State of Arizona beginning in January 2021. Towards the end of Fiscal Year 2020-21, the City of Phoenix started receiving 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. Highway User Revenue Fund (HURF) proportional allocation.
4. State-shared sales tax revenue.

As part of the PSPRS Pension Funding Policy for Fiscal Year 2022-23, City Council

adopted a policy to annually direct revenues from 1 and 2 above (the general fund portion of the City's sales tax of recreational marijuana and the City's Public Safety allocation) to paying down PSPRS pension liability. To date, \$16.2 million has been used to pay towards PSPRS, above the Actuarially Determined Contribution (ADC). Revenues in the current fiscal year from 1 and 2 above are estimated to be approximately \$10.0 million.

City Council Considerations

In accordance with State law, the City Council must formally accept the assets and liabilities of the City's pension funds for the City of Phoenix (**Attachments G and H**) and must approve Pension Funding Policies (**Attachments B and C**) by July 1, 2022.

Pension Obligation Bonds (POBs) are bonds issued to pay pension plan liabilities. This type of bond issuance is very complex and as such, has many critical considerations. As part of the PSPRS Pension Funding Policy for fiscal year 2023, City Council adopted a framework establishing parameters around issuing POBs to mitigate risks. This framework is included as part of the proposed PSPRS Pension Funding Policy for Fiscal Year 2023-24. The policy establishes a framework only. Additional City Council authorization would be required for issuance of POBs.

The City has allowed the Deferred Retirement Option Plan (DROP) Tier 1 members (who entered prior to July 6, 2022) to be eligible to extend their DROP service from 5 to 7 years in accordance with the statutory guidelines when in the best interest of the City; this will be evaluated annually and, on a case-by-case basis.

While the pension systems are not currently fully funded, the strategy to pay the ADC and pay down the liability over a set period (18 years remaining for PSPRS and 15 years remaining for COPERS) allows flexibility in improving services to the public while spreading the liability over a period of time.

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

Responsible Department

This item is submitted by City Manager Jeffrey Barton and Chief Financial Officer Kathleen Gitkin.

Attachment B City of Phoenix City of Phoenix Employee 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 Arizona Revised Statute §38-863.01.

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.

Actuarially Determined Contribution (ADC) – Is the annual amount determined to pay into the pension funds, as calculated 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 ADC 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.

CITY OF PHOENIX EMPLOYEE RETIREMENT SYSTEM (COPERS)

COPERS is a single-employer defined benefit pension plan, covering all full-time general employees of the City except sworn police and fire employees. COPERS is governed by a separate Board, established in the City Charter.

Council formally accepts the assets and liabilities of the City’s COPERS trust funds from the June 30, 2022 actuarial report, which are detailed below.

| Trust Fund | Assets | Liabilities | Unfunded Liability | Funded Ratio |
|-------------------|------------------------|------------------------|---------------------------|---------------------|
| Phoenix | <u>\$3,242,686,938</u> | <u>\$4,723,290,827</u> | <u>\$1,480,603,889</u> | <u>68.65%</u> |

For comparative purposes, the City of Phoenix total Unfunded Liability for the prior fiscal year ending June 30, 2021 was \$1.1 billion and the funded ratio was 75.70%.

COPERS Funding Goal

Fully funded pension plans are the best way to achieve taxpayer equity. However, COPERS is currently 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 \$1.5 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 COPERS funding ratio goal is 100% (fully funded) by June 30, 2039.

Council has taken the following actions to achieve the June 30, 2039 goal:

- Maintain ADC payment from operating revenues – Council is committed to maintaining the full ADC payment (normal cost and UAAL amortization) from operating funds. The budget for the ADC for FY 23 is \$208.0 million.

To achieve this goal, the City's funding policy is as follows:

1. Maintain the City's legal commitment to employees and retirees by paying 100% of the ADC
2. Continue to seek opportunities to advance payments from enterprise and/or specialty funds
3. Evaluate COPERS current year total actual expenditures, if less than the total budget, make an additional payment directly to COPERS
4. Review investment rate of returns on pension assets, monitor actuarial assumption changes and analyze the impact on future actuarially determined contributions
5. Compile sensitivity and scenario analyses on proposed COPERS Board changes to the pension plan
6. 100% funded by 2039