STAFF REPORT

May 25, 2022
File Number 0440-35

SUBJECT

PENSION OBLIGATION BOND WORKSHOP

DEPARTMENT

Finance

RECOMMENDATION

Request the City Council receive information on Pension Obligation Bonds and authorize staff to return to the City Council on June 22 for approval to move forward with the initial process of seeking court validation to issue bonds.

Staff Recommendation: Receive and File (Finance: Christina Holmes)

Presenter: Christina Holmes, Director of Finance

FISCAL ANALYSIS

Ongoing information for budget planning purposes.

PREVIOUS ACTION

On January 26, 2022 City Council received information on the City's California Employees Retirement System pension obligations.

BACKGROUND

The City of Escondido ("City") provides retirement benefits to its employees who provide the City services residents rely on, by contracting with the California Public Employees Retirement System (CalPERS). Retirement benefits are funded by contributions from both employees and the City ("normal" annual service costs) as well as investment earnings. Annual contribution amounts are determined based on a percentage of payroll and in accordance with an actuarially based funding policy. The actuarially-determined pension funding plan determines exactly how much should be contributed each year to ensure that the benefits being earned will be securely funded in a systematic fashion. Since actuarial assumptions are for the long term, demographic and economic assumptions can vary from actual experience. There are many factors considered such as mortality experience, retirement rates, disability incidences, salary growth, investment returns and more. An actuarial plan valuation is therefore prepared each year to true-up contribution levels to better match actual experience.

CalPERS invests contribution payments with the goal of earning sufficient returns over the long-term to pay defined benefits as promised and cover CalPERS expenses. Historically, more than 60% of all funds paid to CalPERS retirees comes from investment earnings. The estimated long-term average return expected to be earned on investments is referred to as the "discount rate". When lower investment earnings occur, future contributions must increase to make up the expected difference and an unfunded accrued liability ("UAL") is created. The UAL represents the shortfall or gap between what is needed to pay retiree benefits versus how much in current assets the City actually has in its accounts with CalPERS. The UAL is calculated annually and changes depending on the demographic trends of the plan participants.

For many years, due to positive investment returns, CalPERS cities were "superfunded," meaning total plan assets exceeded the total CalPERS projected liability. However, during the Great Recession and resulting downturn in the economy, investment returns were impacted negatively nationwide, including CalPERS investments, decreasing the City's total plan assets and creating an unfunded liability. In addition to the investment losses, adjustments have been made to demographic assumptions such as higher retirement rates, and also the expectation that retired employees are living longer, which have also contributed to the increasing liability.

As noted above, the UAL is the shortfall between what the City has in assets vs. what it will need to fully pay the benefits that it has committed to its employees and retirees. The UAL is essentially the City's debt owed to CalPERS, and CalPERS charges the City a 6.8% interest rate on this debt with a mandatory payment schedule. Over the last 5 years, the City's UAL for its CalPERs Miscellaneous and Safety Plans has grown 21%, from $221 million to about $267 million (06/30/20 Actuarial Valuation Report, most recently available). The table below reflects the UAL from the most recent CalPERS actuarial valuation as of June 30, 2020.

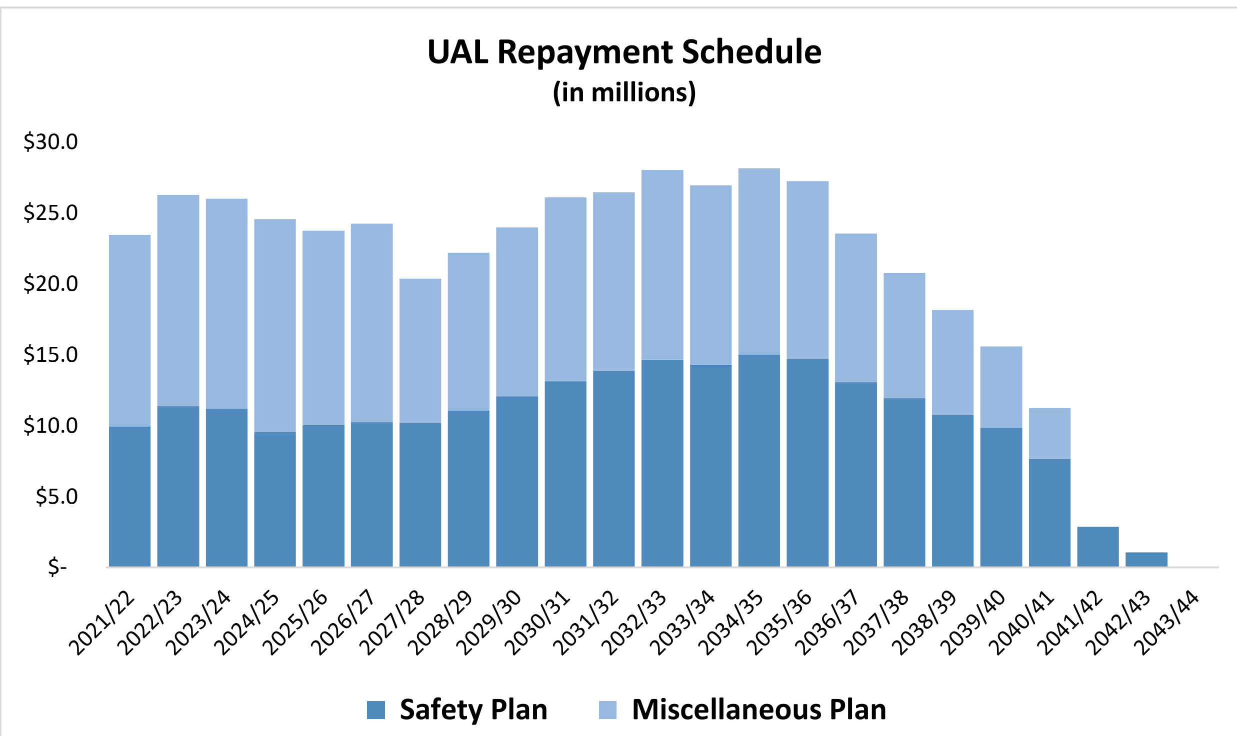
City of Escondido UAL Calculation Based on CalPERS 06/30/2020 Valuation					
			Miscellaneous	**Safety**	**Total**
A	Entry Age Normal Accrued Liability		$459,862,821	$434,370,502	$894,233,323
B	Market Value of Assets (MVA)		$318,091,829	$309,037,732	$627,129,561
C	**Unfunded Accrued Liability (UAL)**	**A - B**	**$141,770,992**	**$125,332,770**	**$267,106,762**
D	**Funded Ratio**	**B / A**	**69.2%**	**71.2%**	**70.1%**

CITY of ESCONDIDO

STAFF REPORT

CalPERS and the City of Escondido have taken a number of actions to address unfunded liabilities across its member plans with the objective of reaching 100 percent funded status. Since December 2016, CalPERS has been lowering its discount rate in recognition that its assumptions about the rate of return on investments have been overly optimistic. The discount rate was lowered from 7.5% to 7.0% over a 3-year period beginning with the June 30, 2016 valuation. Without any offsetting action, reducing the discount rate increases costs to member agencies in the short-term. In the long-term, the reduced rate is expected to lower the cost to member agencies as CalPERS is more likely to achieve the investment earnings target. When CalPERS last reduced its discount rate, causing employer liabilities to significantly increase, CalPERS also implemented a "ramp up" strategy to smooth out the increases in UAL contributions. As opposed to a fixed-level payment schedule, CalPERS began using a 25-year amortization schedule where payments are ramped up in the beginning years and ramped down in the ending years.

As a result of these actions, annual payments made to CalPERS to amortize the UAL have grown rapidly from $10 million in FY2017/18 to $19.7 million in FY2022/23. The chart below shows the current CalPERS unfunded liability amortization schedule for the Miscellaneous and Safety Plans. The General Fund is responsible for 100% of the Safety Plan and approximately 56% of the Miscellaneous Plan payments. The remaining portion of the Miscellaneous Plan is funded by the Water, Wastewater, and Internal Service Funds.



Pension cost increases are one of the largest financial challenge facing most cities throughout the state and are primarily due to factors outside of the cities' control, namely actuarial assumption changes made by CalPERS and below average investment returns. CalPERS and the League of California Cities have detailed various options available to help manage pensions. There is no perfect solution to managing a City's pension obligations and many agencies employ multiple methods to manage their pension obligations. The most typical options include:

1. Identify new sources of revenue to help defray the costs of the City's pensions,
2. Using cash reserves to make additional payments to CalPERS or to the City's Section 115 Pension Trust Fund to help stabilize yearly fluctuations in pension rates,
3. Pursue a CalPERS Fresh Start which allows an agency to consolidate multiple amortization bases (different components of the UAL) into one base paid off over a shorter period. While annual payments will increase, the UAL can be paid off earlier and it would save the City money over the long-term, or
4. Restructure the UAL at a lower interest rate, such as a Pension Obligation Bond.

PENSION OBLIGATION BONDS

Pension Obligation Bonds ("POB") allow an agency the ability to "refinance" some or all of their UAL with CalPERS (the City still needs to pay 100% of the normal cost) that has an effective interest rate of 6.8% with taxable bonds at a lower market rate. The overall strategy of POBs is to achieve interest rate savings (i.e. arbitrage) between the 6.8% and market rate bond issuance.

A POB issuance restructures the City's UAL obligation to CalPERS into an obligation to investors. The issuance provides a lump sum that is remitted to CalPERS which reduces or temporarily eliminates the City's UAL obligation to CalPERS and replaces it with an obligation to investors. Instead of paying CalPERS 6.8% on the obligation, POBs are currently being sold to investors at or below 4%.

The City will always have some version of a UAL with CalPERS because investment earnings will never exactly hit the CalPERS target and actuarial assmptions will change each year. So even if the City paid off the current UAL with CalPERS or issued POBs and paid those off, it does not prevent the addition of some level of UAL in the future. However, once the current UAL or POBs are paid in full, the amount of the UAL that arises in the future should generally, absent large investment losses, be able to be remedied annually, or shortly thereafter, because it would be significantly less.

<u>Potential Benefits of Pension Obligation Bonds</u>:

There are several potential benefits the City could realize by issuing POBs. These potential benefits include:

1. A tool for fiscal sustainability,
   POBs provide the ability to alter the City's UAL payments in a way that could support long-term financial sustainability, help provide budget predictability and minimize the year over year variability in payments, and provide enhanced resiliency to economic shocks.

2. Budgetary savings,
   Using POBs to modify the current CalPERS UAL payment schedule's peak in projected payments to a more predictable or level structure can create cash flow savings.

3. Interest rate "savings" from arbitrage,
   Issuing POBs at market rates that are lower than what CalPERS charges on the UAL creates interest savings through arbitrage. In this example, arbitrage is created by taking advantage of the difference between the CalPERS rate of 6.8% and current market rates. All else being equal, the City would realize a lower cost of debt.

4. Maturity modification, and
   A POB may have a shorter or longer repayment period based on market conditions and the financial objectives of the issuer. However, if the POBs are structured with deferred principal amortization or repayment longer than the actuarial amortization period the overall cost of debt may increase. Further lengthening the debt repayment period adds risks and is specifically noted in the Government Finance Officers Association advisory against POBs.

5. Preservation of reserve and service levels.
   Potential savings achieved through a POB issuance could reduce the need to use reserves to fund ongoing expenditures or reduce service levels.

<u>Potential Risks of Pension Obligation Bonds:</u>

The Government Finance Officers Association (GFOA) Advisories identify policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. The GFOA has issued an Advisory that recommends state and local governments do not issue POBs as there are several risks associated with issuing POBs. These potential risks include:

1. It turns a "variable" obligation into a "fixed" obligation,
   The City's UAL obligation to CalPERS will change year over year. It could increase or decrease based on a variety of factors such as investment returns or actuarial assumption changes. This allows the City to benefit from UAL decreases (i.e. lower payments to CalPERS) but does also mean the City is negatively impacted by increases (i.e. higher payments to CalPERS). Issuing a POB

transfers and refinances the obligation due to CalPERS into a fixed obligation due to investors. An obligation due to investors will not increase or decrease over time which can be beneficial under the right conditions as it limits downside risk associated with an increasing UAL. However, it also carries risk as a fixed obligation because it cannot take advantage of a consistently decreasing UAL.

2. Low pension fund returns,
   If CalPERS investment earnings are below its current discount rate of 6.8% in a given year, the City's UAL will increase from the addition of a new amortization base to reflect the investment earnings shortfall. This investment shortfall is applied to the City's Market Value of Assets (MVA) which will be higher after the issuance of POBs. The new amortization base from the investment shortfall will be larger given the MVA is higher resulting in a larger amortization base than the City would have had before issuing POBs. The City's funded ratio would still be higher, however.

3. "Too much of a good thing,"
   If CalPERS investment returns consistently exceed 6.8% after the City issues a POB, the City's pension plan could become super-funded (i.e. has placed more money with CalPERS than is necessary to cover its pension obligations). Because the POBs become a fixed obligation, the City would not benefit from these surpluses (required contributions would not decrease as the Normal Cost must always be paid) which means the City loses the benefits of cash it could have used on other city services.

4. Future UAL can still change,
   The City will always have some UAL or the potential for some UAL. Issuing POBs does not eliminate the City's UAL obligations; it merely refinances the City's UAL obligations as of a point in time. This will occur as a result of things such as CalPERS investment returns, future changes in the CalPERS discount rate, changes in actuarial assumptions, etc.

5. Market timing risks,
   Market timing risk is related to the timing of the investment of the bond proceeds. A POB issuance produces a lump sum of proceeds which must be remitted to CalPERS immediately after issuance. This lump sum concentrates market timing risks rather than spreading it. This is especially a consideration in the current economic environment as equity markets are at all-time highs. If a market crash occurred between the bond sale and CalPERS investment of the bond proceeds, which is typically two weeks apart, the initial investment cost would be lower and could potentially provide higher future returns. However, if a market crash occurred after the initial investment of bond proceeds, it would negatively impact future earnings given the decreased potential for compounded earnings. It would also likely result in a new amortization base and increase in UAL all else being equal.

6. Increased bonded debt and credit risk,
   Issuing POBs would reduce the City's UAL but increases its bonded debt potentially using up debt capacity that could be used for other purposes. Having more bonded debt may also impact the City's credit rating. S&P Global Ratings views POBs in environments of fiscal distress or as a mechanism for short-term budget relief as a negative credit factor. That being said, S&P also identifies a large liability to CalPERS as a credit negative and there have been many POB issuers, Chula Vista is a recent example, that did not receive a downgrade in rating associated with the issuance.

7. Judicial validation process, and
   The City must proceed through a judicial validation process to issue POBs. This legal filing may be challenged in court proceedings and, if a challenge was successful, prevent the issuance of POBs.

8. Political process.
   POBs can be controversial because, among other things, some view them as gambling on future market returns and they've received a negative reputation due to well publicized bankruptcies (Detroit, Stockton, and San Bernardino). Stakeholders, constituents, and interest groups may be critical of using POBs as an option for managing the City's pension obligations.

Since February 2019, 36 cities throughout California have issued POBs to refinance their UAL in an attempt to accomplish similar goals. The City of Chula Vista, City of El Cajon, and City of Poway are San Diego County cities that have issued POBs recently.

JUDICIAL VALIDATION PROCESS

Authorizing the judicial validation process is the first step in issuing POBs. While this is the first step in the POB issuance process, it <u>does not obligate</u> the City to issue POBs. California public entities do not have specific authority to refinance pension debt by issuing bonds. Pursuant to the judicial validation process, the Court will issue a judgment confirming that the contract with CalPERS and the pension UAL are each an "obligation imposed by law" under the State Constitution which can be refunded under the provisions of the Government Code. This ruling allows local agencies to refund outstanding debt without additional voter approval. Unless challenged, the judicial validation proceedings are largely administrative and may be managed by special legal counsel.

The validation proceedings take approximately 90 - 120 days. The proceedings typically include the following:

1. File Validation Action with San Diego County Superior Court
2. Receive Order for Publication of Summons from the Court
3. Legal publication for 21 consecutive days
4. Waiting period for ex parte (a decision decided by a judge that doesn't require all parties to the dispute to be present) application to file default judgment

5. Clerk enters default judgement and schedules a hearing (hearing for default judgement and entry of judgment
6. Appeal Period (30 days)

Although the issue has not been litigated extensively in California, dozens of prior default (i.e. uncontested) validation judgments have determined that pension liabilities are obligations imposed by law and therefore exempt from the debt limitation requirements set forth in Article XVI, Section 18 of the California Constitution. Staff does not anticipate a judicial validation process for the City of Escondido will proceed differently.

NEXT STEPS

City staff have engaged the services of three consultants that are subject matter experts that will form the financing team and provide objective information on issuing POBs. Assisting staff with the POB analysis and potential debt issuance are CSG Consulting as municipal advisor, Stradling Yocca Carlson & Rauth as judicial validation and bond counsel, and Stifel, Nicolaus & Company, Inc. as bond underwriters.

City staff will return to City Council on June 22 with the bond consultant financing team to present a risk analysis and options for the potential issuance of a pension obligation bond for the City of Escondido. City staff will also be requesting City Council’s approval to move forward with the judicial validation process.