City of RIVERSIDE
City of Arts & Innovation

Finance Committee

TO: **FINANCE COMMITTEE** **DATE: JANUARY 15, 2020**

FROM: **FINANCE DEPARTMENT** **WARDS: ALL**

SUBJECT: **CONCEPTUAL USE OF PENSION OBLIGATION BONDS TO RESTRUCTURE THE CALPERS UNFUNDED ACCRUED LIABILITY**

ISSUE:

Receive and provide input on the conceptual use of pension obligation bonds to restructure the City's Unfunded Accrued Liability with California Public Employees' Retirement System CalPERS.

RECOMMENDATIONS:

That the Finance Committee:

1. Receive and provide input on the conceptual use of pension obligation bonds to restructure the City's Unfunded Accrued Liability with California Public Employees' Retirement System CalPERS to create the potential for General Fund savings and longer-term financial stability; and

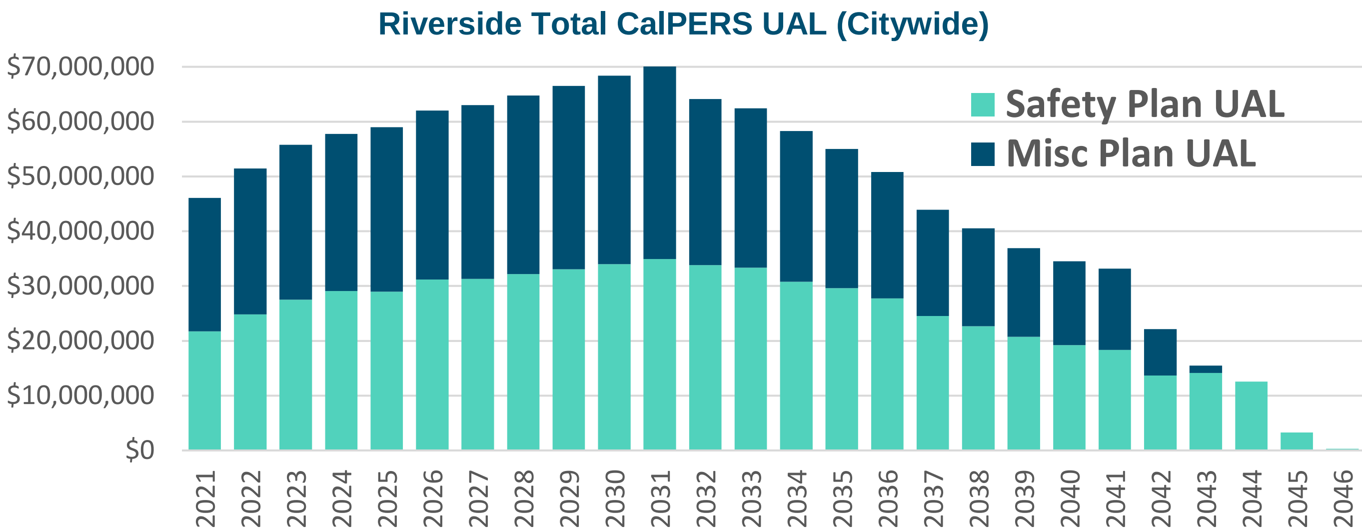
2. Forward a recommendation to City Council to provide direction to the Finance Department to continue the required due diligence, to engage an underwriting team, legal team, and actuary in order to fully assess options, conduct sensitivity analysis and develop an optimal Restructuring Plan.

BACKGROUND:

The California Public Employees' Retirement System (CalPERS) Board of Administration has approved several changes to improve the funded status of the retirement plan, including lowering the discount rate assumption from 7.5% to 7.0%, modifying amortization methods, and updating assumptions about life expectancy. These relatively recent changes have resulted in increases in employer contributions for all agencies participating in CalPERS. Based on the most recent CalPERS actuarial report, it is currently anticipated that the City's pension costs will increase by approximately 28% by Fiscal Year 2024/25 and continue to grow through FY 2030/31.

Staff has been exploring various strategies to reduce pension costs, lower our unfunded liability, and prevent service reductions. The conceptual use of Pension Obligation Bonds, as discussed in more detail below, potentially provides for an opportunity to address forecasted deficits largely caused by increases in pension costs

The City provides regular and limited-term employees retirement benefits offered through CalPERS. Retirement benefits are provided through one of two plans: safety plans for sworn police and fire employees, and a plan for all other (miscellaneous) employees. According to the most recent CalPERS actuarial valuation as of June 30, 2018, the City's total UAL is $627 million. This number is projected to be $642 million as of June 30, 2020, which is the amount that the FY 2020/21 UAL payment scheduled for July 1, 2020 will be based upon. The chart below depicts the projected repayment schedule (by plan) of the $642 million at a 7.0% interest rate, which is the interest rate CalPERS assesses on the UAL.



Annual payments are projected to grow from $45 million to $70 million over the next decade and are the primary driver behind the City's projected annual budget deficits.

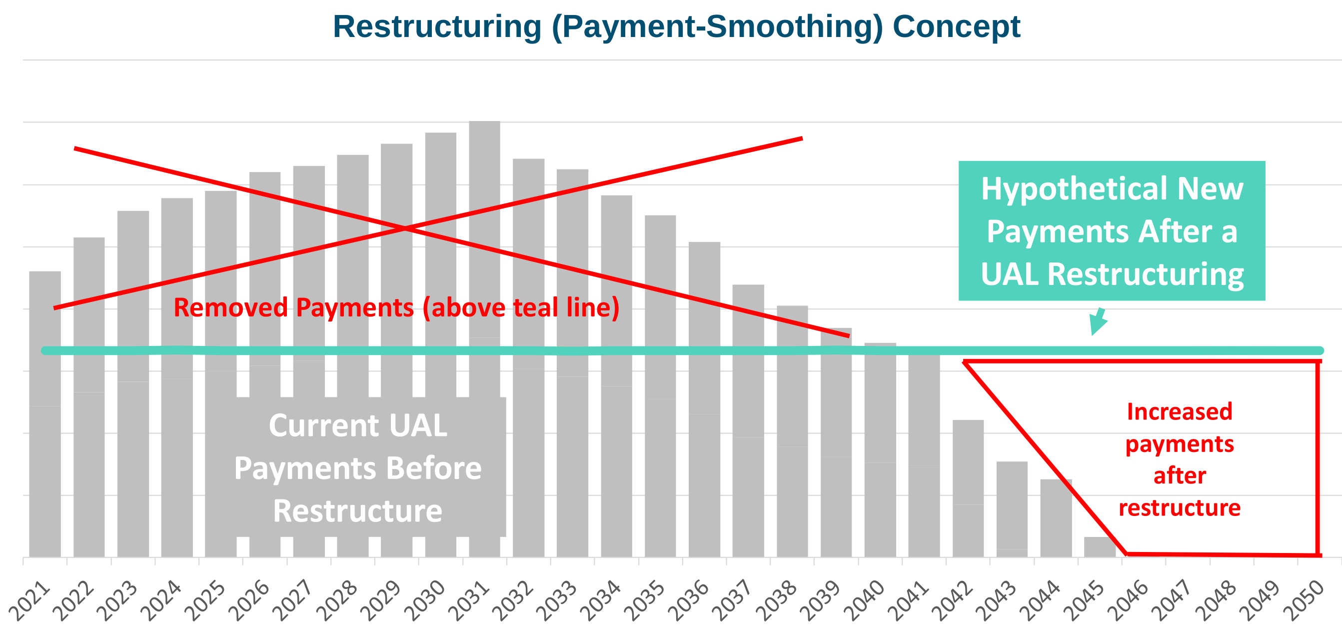
DISCUSSION:

The City is exploring restructuring its UAL through a pension obligation bond (POB). The City has previously issued POBs in 2004 and 2005 (refinanced several times for interest rate savings - most recently in 2017). It is estimated that the City saved millions of dollars over the past 15 years. The restructuring concept entails borrowing money at interest rates (currently < 4.0%) lower than CalPERS is charging on the City's UAL (7.0%) and using that money to pay off a portion of its UAL. The City would then have the flexibility to amortize the new payments to create a smoother, and more predictable overall repayment shape that also generates significant cash flow savings.

Recent POB Issuance and Smoothing Strategy

In the 1990s and 2000's, pension bonds were widely used across the nation. Pension bonds fell out of favor after the bankruptcy judges for Stockton and San Bernardino placed PERS contributions in a priority position to pension bond payments owed to investors. Additional negative sentiment was delivered with the Government Finance Officers Association position of discouraging the use of pension bonds, primarily due to reinvestment risks.

Over the last two years, historically low interest rates, increasing market receptivity, and new payment-smoothing techniques have all contributed to a re-emergence of the POB market. Several cities have recently issued POBs, including the cities of Glendora, Monrovia, Hawthorne, La Verne, Marysville, Chowchilla, Baldwin Park, Pacifica, and Brawley, as well as several others in process. Many of the cities have created a new, smoother payment shape. This strategy is conceptually depicted below and often includes a slight maturity extension.



This strategy is not without risks, notably reinvestment risk and market timing risk. The potential benefits and risks/considerations are discussed below and highlighted in even more detail in the attached presentation.

Potential Benefits of a UAL Restructuring:

The primary potential benefits of a UAL restructuring include:

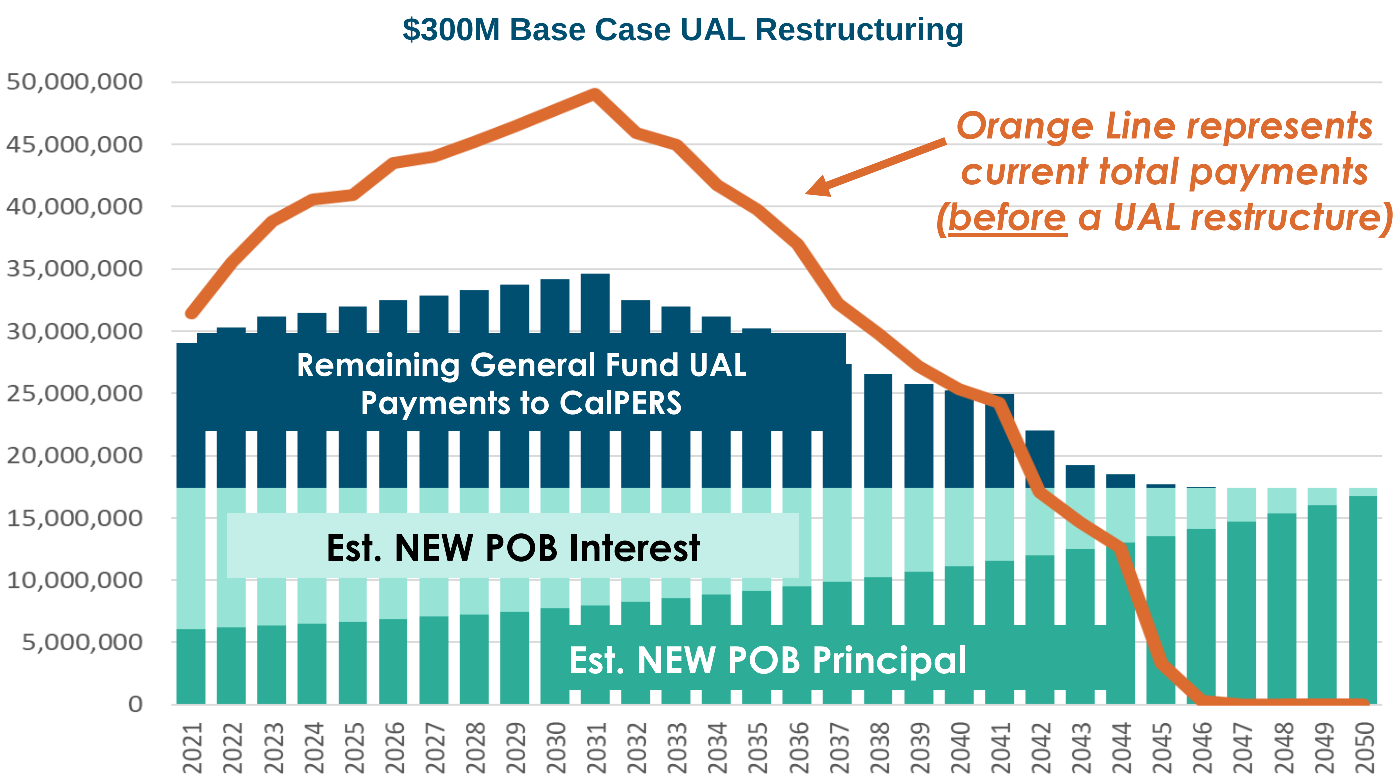
- <u>Enhanced Fiscal Sustainability, Budget Predictability and Stabilized Costs</u> – due to restructuring payments into more level shape
- <u>Near-Term Budgetary Savings</u> – short term layers of the current UAL would be paid off, thereby removing a portion of the near-term peak in payments
- <u>Interest Rate Savings</u> – there is potential for interest rate savings given that borrowing rates are currently under 4.0%
- <u>Increase Funding Ratio of Pension Plan</u> – current funding levels are between 70 and 80% for each plan; a restructuring could increase them to above 90% for one or both of plans
- <u>Flexibility to Modify Maturity (Shorten or Lengthen)</u> – City has the option to shorten or lengthen maturity based on objectives; given the flat nature of the interest rate yield curves, there is not much penalty to borrowing over a longer period in the current market
- <u>Preserve Service Levels</u>– to the extent that a restructuring can act as the primary solution to addressing the deficits, reducing service levels for pensions may not be required
- <u>Matching Assets to Liabilities</u> - Prudent fiscal policy is to match useful life of assets to liabilities; PERS benefits likely paid out well beyond 25-30 years

Potential annual savings over the next 15 years is dependent on the size of the restructuring as well as the new amortization shape of the payments. In general, the larger the size, the larger the potential savings. However, a larger issuance also carries more re-investment risk than a smaller size. Based on preliminary analysis (and current interest rates) by the City's municipal advisor (NHA Advisors), the following is a summary of the estimated annual near-term (first 15 years) savings of various sizes of restructurings:

- Small $150M - $200M (25-30% of UAL); $5M to $9M in average annual savings for first 15 years
- Medium $250M - $375M (40-60% of UAL); $10M to $14M in average annual savings for first 15 years
- Large $400M - $600M (60-95% of UAL); $15M to $20M in average annual savings for first 15 years

As the discussion continues, the Chief Financial Officer will evaluate several sizes and amortization shapes to develop refined options for City Council approval that meet budgetary objectives while minimizing risk.

In order to communicate the potential benefits in greater detail, a Base-Case scenario is depicted below and assumes a medium restructuring size - $300 million, or about 47% of the City's total UAL. While solely preliminary, this medium size was chosen to balance risk/reward and maximize savings to the General Fund. As shown below, the total of the colored bars is much lower than the orange line, which is the City's current overall UAL/debt payments attributable to the General Fund. Average annual savings for the next 15 years is about $10 million. Through FY 2040, there is an estimated $170 million of total cash flow savings. Offsetting those savings are higher ($120 million total) payments from FY 2041 to FY 2050. **In cumulative, there is an estimated $50 million of projected cash flow savings even with a maturity extension of about 4 years to 2050.**



Potential Risks of a UAL Restructuring:

There are several risks and considerations to evaluate, most notably re-investment and market timing risks. Any potential savings is estimated and assumes CalPERS earns the target rate of return (7.0%) over the next 25 to 30 years. Actual savings will be dependent on CalPERS future investment returns, with savings lower than expected if CalPERS earns below 7.0% and higher if they earn more than 7.0%. The rule of thumb is that present value savings will be realized if CalPERS earns more than the interest rate that the City pays on the new POB.

A related risk is market timing risk, since a large loss (for example, from a stock market crash) immediately following a lump sum payment to CalPERS to invest (from proceeds of the POB) may mean that the new UAL created would be larger under a POB scenario vs. one where the City did not issue a POB.

The fact that interest rates are at historically low levels naturally mitigates reinvestment risk, as it creates over 300 basis points (3.0%) of cushion between CalPERS expected rate of return (7.0%) and the City's projected borrowing rate (< 4.0%). The Finance Department continues to work with the team of external advisors (Municipal Advisor, Underwriters, Actuary, etc.) to better stress-test a variety of scenarios. This sensitivity analysis will allow the team to quantify the risks and better project potential savings under various types of CalPERS reinvestment scenarios in the future, including recessionary type situations. The team will also help quantify how large of a market-crash the restructuring could withstand and still generate positive savings, as well as the potential benefits from risk mitigation measures.

In addition to better quantifying and illuminating the risks of various structuring alternatives, staff will also seek to evaluate strategies to mitigate these risks. These may include (1) dollar cost averaging the proceeds of the POB given to CalPERS over multiple periods as opposed to just at once, (2) structuring escalating payments (starting lower) in the near term to mitigate the negative impacts from a near term recession or market crash and (3) any other ideas provided as further due diligence is completed.

Proposed Next Steps:

The below schedule includes the due diligence and evaluation that has been occurring over the last two months. If the Finance Committee forwards the recommendation to City Council and City Council directs staff to start the process or issuing POBs a financing team would be engaged in February. After options are further refined, and the sensitivity/stress-testing and credit rating processes are conducted, staff would likely come back to City Council in the Spring for final approval of the financing team and preferred restructuring option.

- January 15: Presentation to Finance Committee; Q&A and direction given
- February 4: Presentation to City Council; Q&A and direction given
- February: Underwriter RFP issued and continued due diligence and evaluation
- Late February/March: Hire UW, Financing team develops legal documents & refined structuring options
- March/April: Actuarial sensitivity analysis; refine final structuring strategy, credit rating
- April/May: Final CC approval; execute restructure and begin paying off UAL with CalPERS

FISCAL IMPACT:

There is no direct fiscal impact associated with presentation of this report. If the City does move forward with executing a UAL restructuring in the Spring of FY 2019/20, annual savings would be generated starting in FY 2020/21 and would be dependent on the ultimate size and structure of the restructuring.

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Attachment: Presentation