CALPERS PENSION COST MANAGEMENT STRATEGIES

Introduction to Pension Obligation Bonds (POB)

Finance Department

Budget Engagement Commission
March 12, 2020

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CHALLENGE

1. CalPERS is coming up short on their investment targets and have failed to generate enough money to fund the pension promises made to public employees.

2. As a result, Riverside's mandatory payments to CalPERS are increasing at a rapid rate, potentially taking funding away from City services for pensions.

   A. The City anticipates its annual retirement expenditures to increase by 18.1% from $87.1 million to $102.9 million ($15.8 million) over the next five years.

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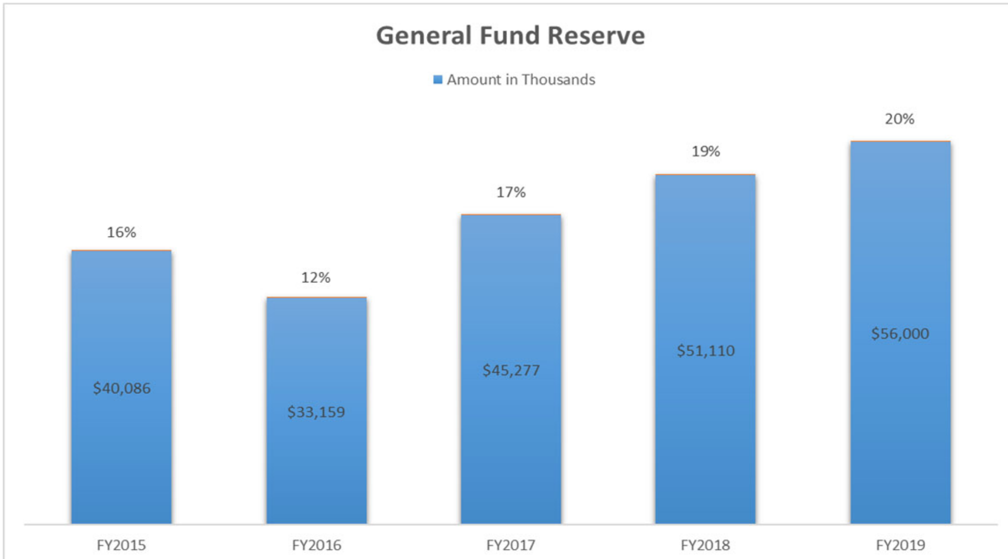

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CalPERS PAYMENTS

Each year, the City makes two types of payments to PERS:

1. **Normal Cost (NC):** Annual cost for current employees
2. **Unfunded Accrued Liability (UAL):** Actuarial Liability MINUS Actuarial Value of Assets
   A. "How much we currently have vs. how much we need to have in the future when people actually retire"
   B. Shortfall not repaid all at once; amortized over a longer period of time with the City paying down a portion each year (principal and interest @7% rate)

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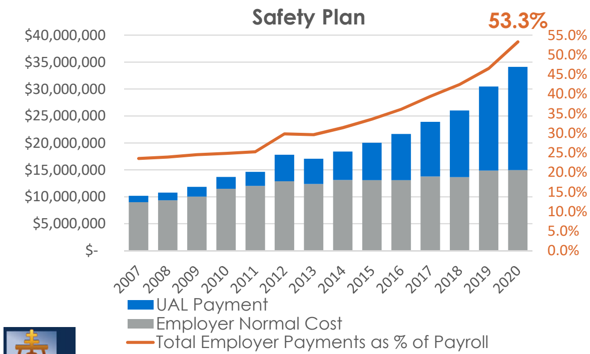
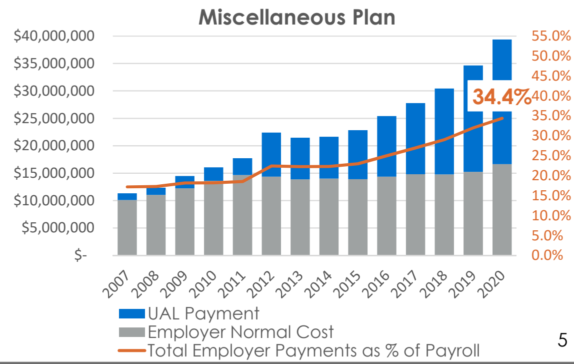
HISTORICAL CalPERS COST TRENDS

Annual UAL and Normal Cost Payments

1. Annual pension costs have more than tripled since 2007
2. As % of payroll, Safety costs have escalated to 53%; Miscellaneous to 34%





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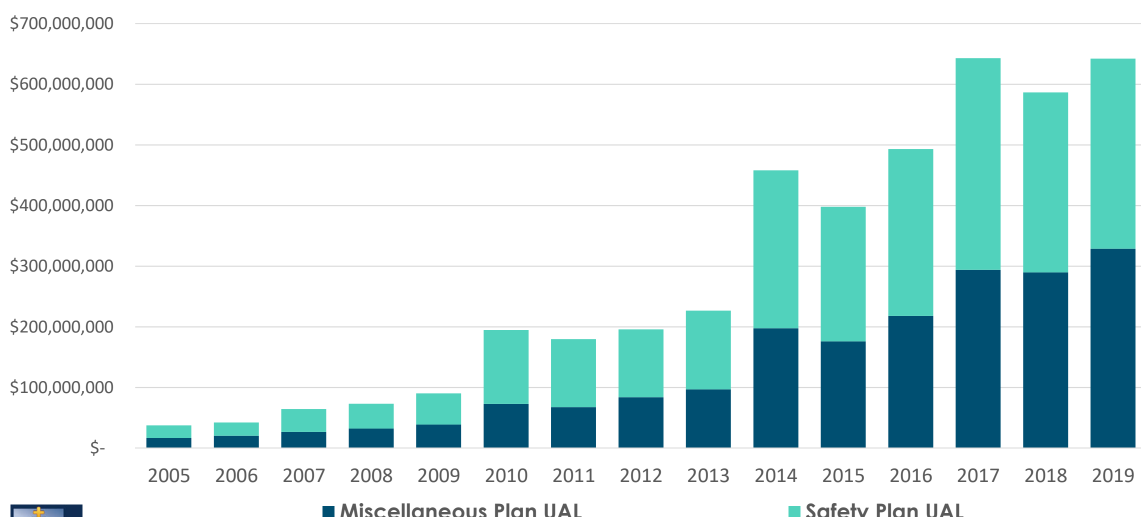
HISTORICAL CalPERS COST TRENDS

Annual UAL Balance Owed to CalPERS



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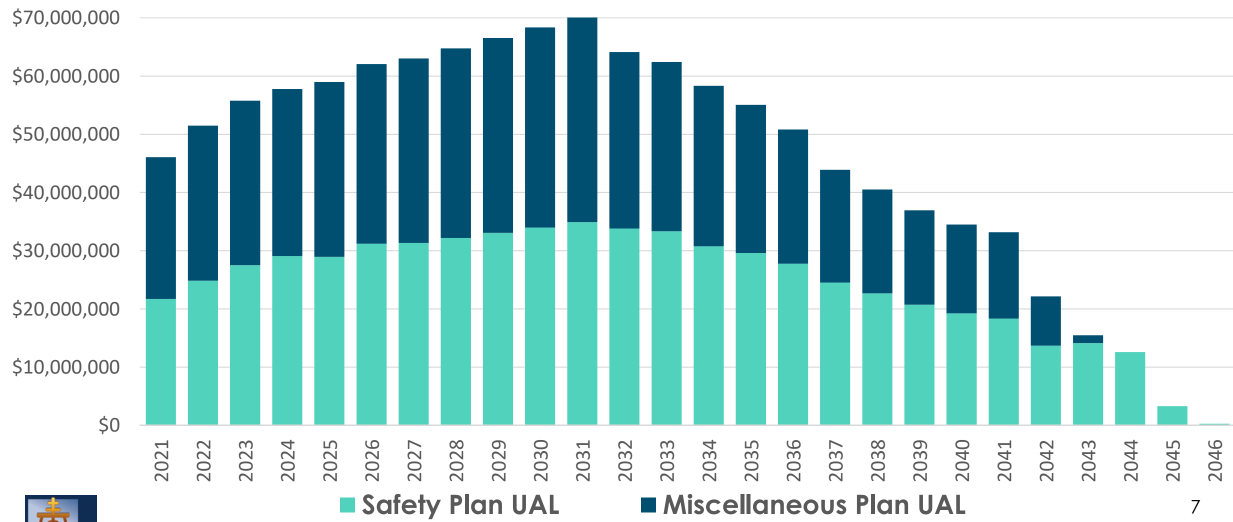
UAL PROJECTED REPAYMENT SCHEDULE



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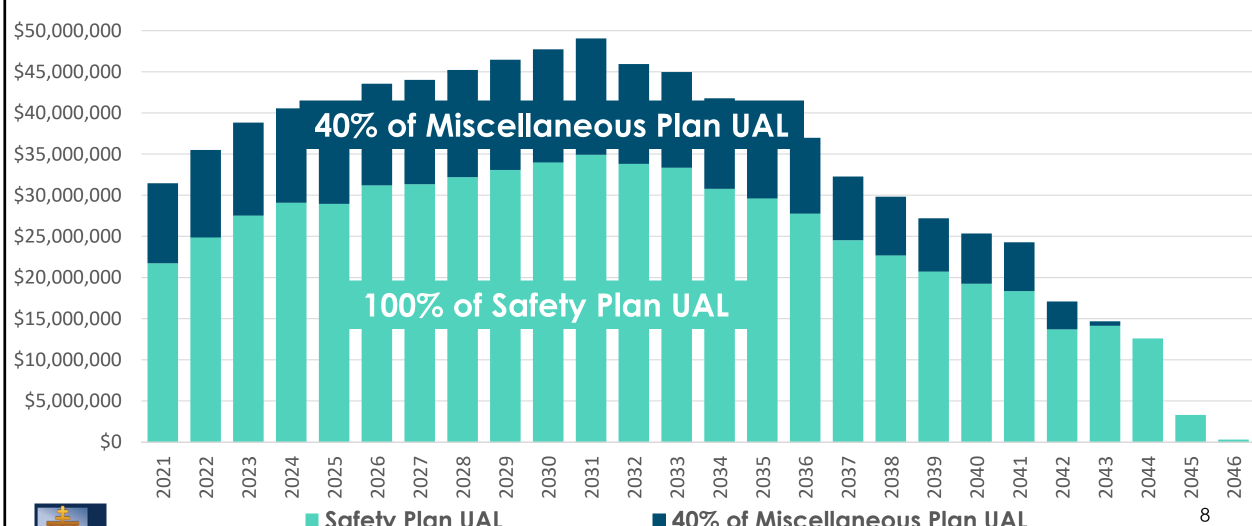
GENERAL FUND ONLY: UAL PAYMENTS



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RIVERSIDE HAS HISTORICALLY TAKEN PRO-ACTIVE STEPS TO MANAGE PENSION COSTS

- 2003-2005: City issued POBs to extinguish UAL at that time and reduce payments
- 2011-2012: All new employees begin paying the employee portion of PERS pension costs
- 2013: Established lower pension benefits for new employees, resulting in lower pension costs (PEPRA)
- 2016: City bargaining units agree to begin paying for their share of pension costs (phased in over several years)
- 2017: Refinanced $30 million Bond Anticipation Note; fixed rate POB and accelerated 10-year amortization
- 2017 – 2019: Finance Committee and Budget Engagement Committee presentations
- 2018-2019: CalPERS Challenge project initiated with weekly meetings + Adoption of Pension Funding Policy + Creation of Section 115 Trust
- 2018 – 2020: Pre-pay UAL at beginning of FY to save 3.5% ($1.2M to $1.5M annually)
- Every Year: Implement operational efficiencies, where possible, to minimize costs and impact to service levels as CalPERS costs increase

LONG TERM FISCAL PLANNING

1. Pension Stabilization Fund, Section 1115 Trust (completed with ongoing contributions)
2. Engagement with external Financial Advisors for long term fiscal solvency (ongoing)
3. Managed Hiring (ongoing)
4. **Pension Obligation Bond (POB)** (current discussion)
5. Measure Z (as necessary)
6. Use of Reserves (as necessary)
7. Service level reductions (last resort, not recommended)

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ADDRESSING UAL DEBT

1. The City can borrow money and use that money to pay off all or a portion of its debt (UAL) with CalPERS
   A. Typical method is through a Pension Obligation Bond (POB)
      i. Bond is issued to investors
         a. City has utilized this strategy on several occasions in past to generate savings
2. Interest rate paid on the new debt would be significantly lower than the 7% currently being paid on the UAL debt
   A. Most importantly, the City can restructure its annual payments in a manner that works better for the City with the opportunity to garner significant cash flow savings

POB HISTORY

1. POBs were commonplace in the 1990's and 2000's
   A. 150+ issued nationwide; over 75 in CA
2. After San Bernardino and Stockton bankruptcies, investors became skittish about purchasing POBs and issuance halted
3. Over last 2 years, investor interest in POBs has grown; feasible for cities who:
   A. Have a strong credit rating ("A" or higher); or
   B. Structure with very short maturity; or
   C. Have a pension tax override (only 22 cities in CA have this)
4. Near record low interest rates in bond market have resulted in strong interest in POB's by CalPERS members

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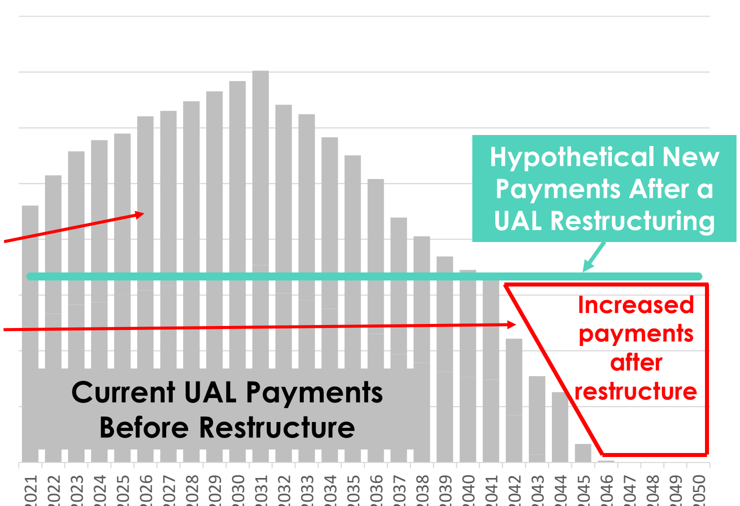
WHAT DO YOU MEAN BY RESTRUCTURE?

The City can create an amortization schedule with a more smooth and predictable shape (teal line)

1. Creates near term savings to address GF Deficits
2. New payments in the out-years higher than currently scheduled
3. **Overall, total payments would be lower than before**



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POB – SUMMARY OF KEY BENEFITS

Fiscal Sustainability Tool	Ability to re-structure the City's pension debt payments in a way that creates enhanced long-term fiscal sustainability, budgetary predictability, and lower/stabilized annual costs
Near-Term Budgetary Savings	By modifying the current near-term peak in scheduled payments into a more level structure, near term cash flow savings are created
Interest Rate Savings	City can borrow at historically low interest rates that are much lower (currently <4%) than those CalPERS is charging on UAL debt (7%)
Increase Funding Ratio	Current ratios are between 71.5% (Safety) and 78% (Miscellaneous); increasing these ratios is viewed as a credit rating positive
Modify Maturity	City has flexibility to shorten or lengthen repayment period to meet financial and policy objectives
Reserves/Services	UAL Restructuring may eliminate need to draw on reserves or reduce services.

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NEAR TERM SAVINGS RANGE

Estimated Savings Dependent on Size of Restructuring

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

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BASE CASE: $300M POB

1. $300M size chosen to balance risk/reward and maximize savings to General Fund
2. Level debt service amortization
3. 30-year maturity

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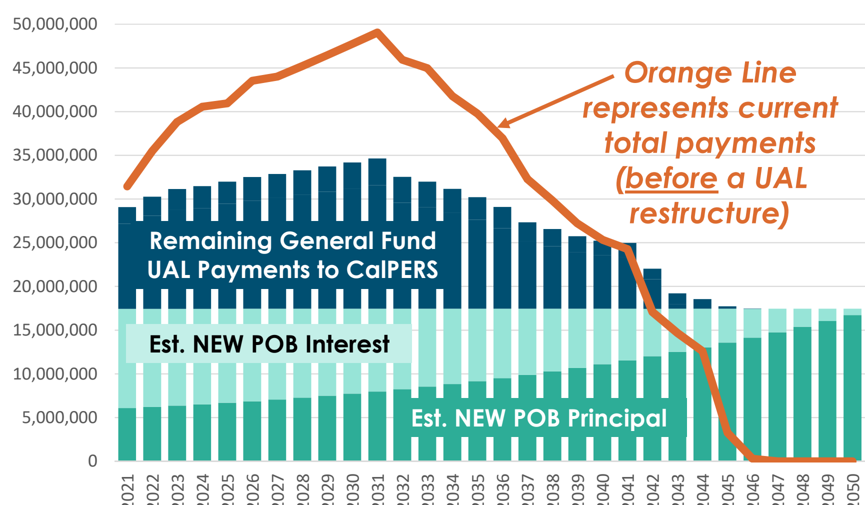
BASE CASE: $300M POB

1. Annual savings for next 15 years ranges up to $14M; **averaging about $10M**
   A. $170M total savings through FY 2040
2. Increased annual payments ranges up to 17.5M from FY 2041 to FY 2050
   A. $120M total increase in payments after FY 2040
3. **Cumulative estimated savings of $50M**
   A. Even with 4-year maturity extension



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Note: All savings estimated; actual savings dependent on interest rates at time of pricing and future CalPERS investment returns

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TAKEAWAYS FROM BASE CASE: $300M POB

1. $300M POB (≈ 47% of total City UAL) could potentially generate over $10M of average annual savings for the next 15 years
   A. More near term savings could be created (at the expense of larger payments in out years) and overall payment shape further smoothed if principal deferral technique is used (see appendix for technical details)
2. The City and its advisor will explore smaller and larger options and various amortization shapes during recommended due diligence period
3. Under any scenario, even a principal deferral one, it is the City's intention to ensure that projected payments after a restructuring are lower than currently projected (without a restructuring)

UAL RESTRUCTURING – SIZING CONCEPTS

Balancing Risk vs. Reward

Less UAL Taken Out =

\+ Lower amount of reinvestment / market timing risk ***BUT***

\- Lower amount of potential savings and ability to smooth payments

More UAL Taken Out =

\+ Largest amount of potential savings and payment smoothing ***BUT***

\- Higher re-investment / market timing risk

CURRENT INTEREST RATES AT HISTORICAL LOWS

30-Year History of the 30-Year Treasury Rate

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RECENT POB ISSUANCES

Monterey Regional FD	(2019)	AA-
Pacifica	(2019)	AA+
Marysville	(2019)	A
Hawthorne	(2019)	AA-
Glendora	(2019)	AAA
Baldwin Park	(2019)	AA-
Chowchilla	(2019)	A+
Tulare County	(2018)	AA-
La Verne	(2018)	AA+
Riverside	(2017)	AA-
Monrovia	(2017)	AA
Brawley	(2017)	A-

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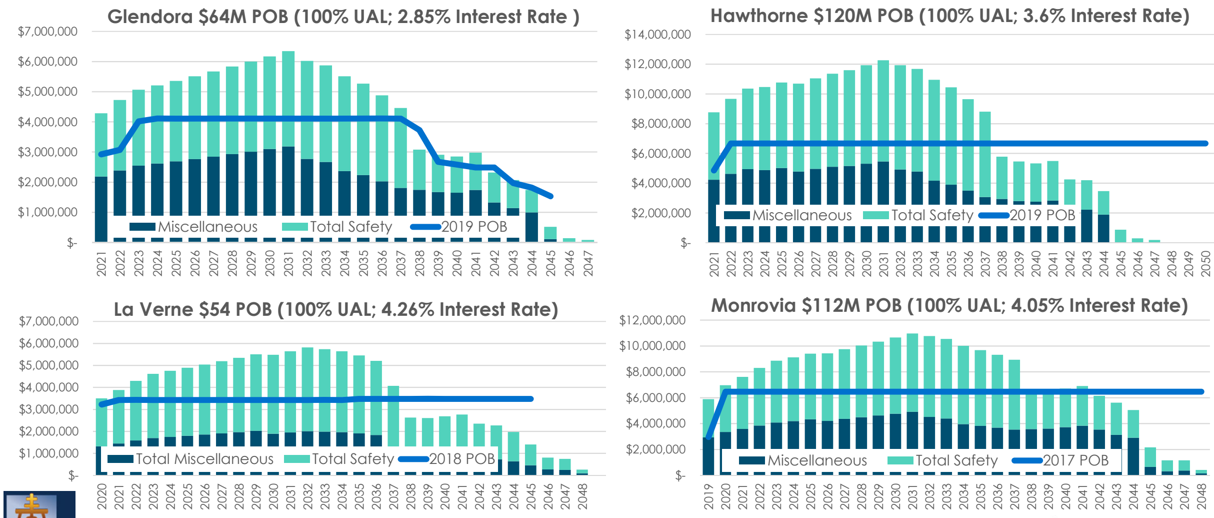
RECENT POBS

Restructuring for Smoothing is a Common Theme



Note: Interest rates and UAL funding all estimated based on review of bond documents

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PRIMARY RISKS AND CONCERNS

(1) Re-Investment/Market Timing Risk

(2) Future UAL Can Still Change

(3) Principal Deferral/Maturity Extension

(4) Increased Bond Debt

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PRIMARY RISK

(1) Re-Investment / Market Timing Risk

- Savings is ultimately dependent on future CalPERS returns; which are unknown at time of issuance
- Present value (PV) savings occur if PERS earns greater returns than POB interest rate
- Near-term losses exacerbate this risk given large lump sum deposit into the market

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ADDRESSING REINVESTMENT/MARKET TIMING RISK

1. Historical returns higher than current interest rates means strong likelihood that PV savings will be generated
   A. 30-year avg PERS returns = 8.1% and 20-year avg returns = 5.8%
   B. Executing restructure when interest rates are low reduces risk (see next slide)
2. Actuarial sensitivity analysis will simulate various "what-if" scenarios to better evaluate a pre-POB vs. post-POB situation
   A. Will include various negative scenarios, including recessionary conditions
3. City and financing team would also evaluate strategies to further mitigate risks, potentially including:
   A. Ramping of near-term debt service to create capacity to handle any immediate adverse economic conditions (such as a stock market crash)
   B. Separate issuances or other ideas to spread market risk
   C. Other strategies developed by financing team (advisor, underwriter, actuary)

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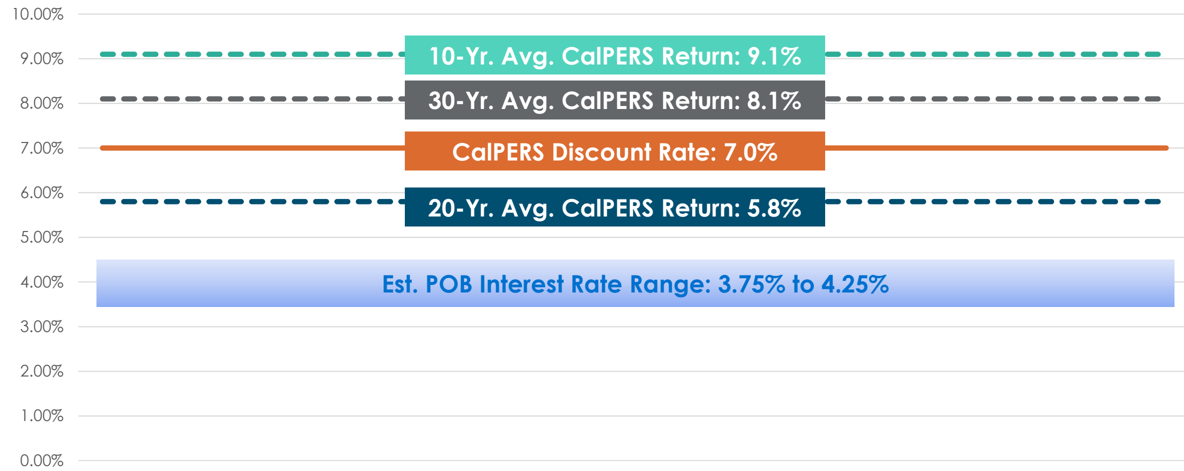
EST. POB INTEREST RATE LOWER THAN HISTORICAL PERS RETURNS & CURRENT DISCOUNT RATE



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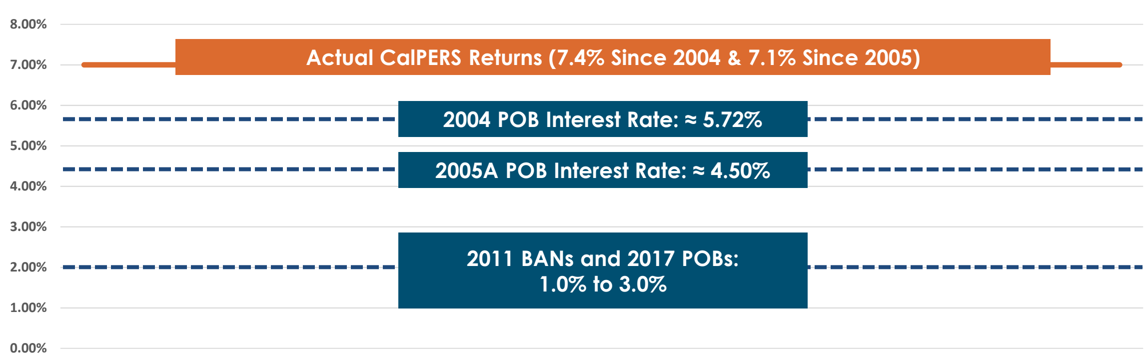
CITY'S PREVIOUS POBS – WAS THERE BENEFIT?

1. City issued roughly $150 million of POBs in 2004 and 2005
   A. Since that time, Great Recession occurred and several assumption changes by CalPERS
2. City engaged actuary to analyze whether City benefited from those POBs
   A. Results: $56 million of savings to City over last 15 years



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ADDRESSING OTHER CONCERNS

(2) Future UAL Can Still Change

- Future UAL will change/occur whether City issues a POB or not
- Near-term losses may mean new UAL added is higher under a POB scenario than without
- Sensitivity analysis and comparison of pre-POB to post-POB will better quantify the difference in UAL fluctuations under various reinvestment scenarios (stress-testing)
- A new smoother/lower repayment shape may provide more capacity/resiliency for the City to handle any future increases in contribution rates from UAL changes

(3) Principal Deferral/Maturity Extension

- Payments may be higher than currently scheduled in the later years
- Even with principal deferral/maturity extension, new payments are lower overall than before
- City is creating a more level payment schedule that enhances long-term financial stability
- Prudent fiscal policy is to match useful life of assets to liabilities; PERS benefits likely paid out well beyond 25-30 years

(4) Increased Bond Debt

- POB would add to the City's bond debt

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LOOKING FORWARD: A Process to Deliver a Carefully Crafted Restructuring Solution

Strategic restructuring tailored to City's General Fund budgetary objectives and minimize risks

- Primary Focus on GF portion of CalPERS costs
- Assess partial Misc. Plan Restructure for additional relief
- Focus on toxic layers of UAL that create near term peak
- Evaluate wrapping of other GF debt to optimize savings

Use actuarial sensitivity model to carefully quantify reinvestment risks and stress-test UAL restructuring options

- Different sizes, different repayment shapes, lots of "what-if" scenarios
- Develop structuring options and pay-off strategy that mitigate risks

Communication of options/risk analysis to stakeholders at future meetings to make prudent decision

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RECOMMENDED SCHEDULE

Jan 15: Presentation to Finance Committee; Q&A and direction given

Feb 4: Presentation to City Council; Q&A and direction given

February Underwriter RFP issued and continued due diligence and evaluation

Late Feb/Mar: Hire UW, Financing team develops legal documents & refined structuring options

Mar/April: Actuarial sensitivity analysis; refine final structuring strategy, credit rating

Apr/May: Final CC approval; execute restructure and begin paying off UAL with CalPERS

RECOMMENDATION

That the Budget Engagement Commission receive this report regarding the conceptual use of pension obligation bonds to restructure the City's Unfunded Accrued Liability with California Public Employees' Retirement System to create the potential for General Fund savings and longer-term financial stability.