Issuance of Pension Obligation Bonds

By Finance Department | Published April 29, 2015

On April 21, 2015, we received the following question:

"Could you explain the mechanics behind the California Statewide Communities Development Authority Taxable Pension Obligation Bonds issued in 2004, the Pension Obligation Bonds issued in 2005, and the Pension Obligation Refunding Bond Anticipation Notes issued in 2014? How have these investments in CalPERS performed versus what the City's paid in interest and fees as part of these issuances?"

In 2004, as a result of the City Council granting retroactive pension benefit increases to existing City employees (as most public agencies in California did around the same time), the City's unfunded pension liability increased. The increase in pension rates was the result of granting a benefit that the pension actuaries at CalPERS did not anticipate in setting the prior pension rates for the City. CalPERS charges public agencies such as the City a rate in the form of a percentage of payroll each year to recover 100% of the amount of pension costs calculated by CalPERS as due that year. When actual experience differs from the actuaries' estimates, an unfunded pension liability or a surplus of funds on hand at CalPERS will result. The City does not have the ability to pay less than the required 100% contribution set by CalPERS each year, but the City may prepay any unfunded amounts owed, either in cash or via the issuance of pension obligation bonds. Absent such a prepayment, CalPERS amortizes the unfunded amounts over a set period through higher pension rates. The amortization period in 2004 was approximately 20 years.

Options were discussed to address the unfunded liability and related increases in CalPERS rates, and it was deemed more advantageous at the time to issue pension bonds than to allow CalPERS to amortize the unfunded liability. On June 29, 2004, the City issued bonds to prepay a portion of the unfunded pension liability associated with public safety employees in the amount of $89,540,000. On June 30, 2005, the City issued bonds in two series to prepay a portion of the unfunded pension liability associated with non-public safety employees in the amount of $30,000,000 (Series A) and $30,000,000 (Series B). These bonds were all 20 year bonds, designed to mirror the amortization period then in use by CalPERS. Issuance of the bonds allowed the City to borrow funds at a lower interest rate than CalPERS would have charged the City through its rates as the unfunded liability was repaid over time, with the difference accruing to the City as savings. The annual rates charged by CalPERS decreased as a result of the issuance of the bonds, and the bond debt service took the place of a portion of the otherwise required annual payments to CalPERS.

The three series of bonds were all approved by the City Council in open session at the time of issuance, however the 2005 Series B bonds require an annual re-approval by the City Council because of the variable rate format in which this debt was issued. The issuance of a pension obligation refunding note is therefore on the City Council's agenda annually in the spring each year. This is not new debt; rather, it is just a re-authorization of the Series B debt outstanding since 2005. All of the City's pension obligation bonds will be paid in full by June 1, 2025. As of today, $66,320,000 remains outstanding from the 2004 bonds and $49,455,000 remains outstanding from the 2005 bonds. On June 1, 2015, the City will be making a total scheduled payment of $7,050,000 on the bonds, further reducing the balance outstanding.

The amounts paid to CalPERS back in 2004 and 2005 from the original bond proceeds are the extent of what has been used to "prepay" the City's pension liability. No bond proceeds or other additional funds have been sent to CalPERS since that

time. However, 100% of the required payments to CalPERS have been made each year as required under California law. The City receives an “Annual Valuation Report” from CalPERS each year in approximately October, which sets the contribution rates required in the following fiscal year (beginning July 1). Those rates are then entered into the City’s payroll system and appropriate amounts are remitted to CalPERS each pay period. Again, the City does not have discretion relative to the minimum contribution amount, and must contribute at a minimum the percentage of payroll outlined in the Annual Valuation Report each year. Copies of the City’s most recent Annual Valuation Reports can be found here: Safety Miscellaneous
In terms of evaluating the savings associated with these bond issuances versus allowing the unfunded pension liability to amortize with CalPERS, the City analyzes the benefit associated with these transactions each year due the variable rate structure of the 2005 Series B debt. CalPERS amortized its unfunded liabilities at 7.75% through 2012 and at 7.50% thereafter. The 2004 bonds were issued at an average rate of approximately 5.1%, while the 2005 bonds were issued at an average rate of 4.5% for Series A and 2.42% to date for Series B. While it is not possible to quantify the exact savings associated with the issuance of all three bonds, the City is comfortable saying that the savings has been considerable versus allowing CalPERS to amortize a larger unfunded liability through rates. This strategy was a cost-effective way to decrease the total cost of funding the City’s pension liability, which has allowed additional resources to be directed to core City services in lieu of higher pension costs. In 2025 when these bonds are paid in full, a significant reduction in annual pension costs is anticipated of approximately $18.5 million per year.

General Fund Reserve Target

By Finance Department | Published April 28, 2015

On April 21, 2015, we received the following question:

“A target of 15% is often quoted as the minimum level the City needs to have in reserves for the General Fund. Where does this target come from? And what would happen if the City were to drop below this percentage?”

The City’s current General Fund reserve target of 15% is calculated at the beginning of each fiscal year as a percentage of the upcoming fiscal year’s General Fund expenditure budget. The 15% target was set by the City Council on February 13, 2001, during a mid-year budget review. The previous target of 10% had been set on April 4, 2000, during a similar mid-year review. Prior to the 10% target, the reserve target was set at $10 million in fiscal year 1999/00 and $5 million in fiscal year 1998/99. Prior to 1998/99, the reserve target was $1,820,000 at least back to fiscal year 1995/96. the following table outlines the historical reserve levels over the past 20 years. In many of these years, actual reserves exceeded these numbers, however only the required 15% or prior reserve target amount was designated for economic contingencies. The remainder of the reserve was available for use at the discretion of the City Council.

Date	Percentage	Reserve Amount
FY 1995/96	N/A	$1,820,000
FY 1996/97	N/A	$1,820,000
FY 1997/98	N/A	$1,820,000

FY 1998/99	N/A	$5,000,000
FY 1999/00	N/A	$10,000,000
FY 2000/01	10.00%	$11,350,000
FY 2001/02	15.00%	$19,700,000
FY 2002/03	15.00%	$21,400,000
FY 2003/04	15.00%	$22,500,000
FY 2004/05	15.00%	$23,500,000
FY 2005/06	15.00%	$27,000,000
FY 2006/07	15.00%	$30,000,000
FY 2007/08	15.00%	$34,000,000
FY 2008/09	15.00%	$34,000,000
FY 2009/10	15.00%	$30,000,000
FY 2010/11	15.00%	$30,000,000
FY 2011/12	15.00%	$32,000,000
FY 2012/13	15.00%	$33,000,000
FY 2013/14	15.00%	$34,000,000
FY 2014/15	15.00%	$36,000,000

During the economic boom times experienced at various points during the 1990′s and 2000′s, the City made a choice to augment its reserves to guard against future fiscal challenges. This has been one of the primary reasons why the City's General Fund continues to receive strong ratings from the bond rating agencies. Recognizing that the current reserve levels are approaching the 15% target including the excess available balance, the City is in a unique situation in the upcoming fiscal year of needing to augment reserves as the budget continues to grow in order to maintain the 15% target level. The budget that will be presented to the City Council in June will include a surplus of revenues over expenditures, with the surplus to be allocated to growing the General Fund reserve and maintaining the 15% reserve target.

The primary concern if the reserve level drops below the 15% target level is that the bond rating agencies would perceive this as a weakening of the City's financial management and a credit negative. The exact level of reserves set is less important than management and the City Council's willingness to maintain it in the face of other spending pressures. Because of the current situation with reserves approaching the 15% level, staff is reviewing the 15% policy to determine whether a higher or lower level of reserves is appropriate as the City continues to grow and the programs in the General Fund continue to diversify. Any recommendations relative to adoption of a more formal written policy or a change in the current reserve target level would come after adoption of the budget for the upcoming fiscal year and a change in the target level would be only following review and approval by the City Council.