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Attachments:	1. Exhibit 1: Schedule of Amortization Base, 2. Exhibit 2: Projected UAL Payment Requirements, 3. Exhibit 3: Level Debt Service to 2038 then Declining to Maturity in 2044, 4. Exhibit 4: Partial Funding, 5. Exhibit 5 GFOA Pension Obligation Bonds, 6. Exhibit 6 Pension Obligation Funding Memo			

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11/5/2019	1	City Council		

Report to Mayor and City Council

Tuesday, November 05, 2019

Discussion

SUBJECT:

PENSION OBLIGATION BONDS (CITY COUNCIL)

I. SUMMARY

The City participates in the California Public Employees Retirement System (PERS) for funding current and retired employees' retirement costs. As of June 30, 2019, the City's plan was approximately 64.8% funded. The current unfunded actuarial liability (UAL) for the plan as of July 2019 is estimated to be $104,983,369. Mayor Albert Robles has requested staff to provide funding scenarios to pay down the UAL and future savings by issuing pension obligation bonds (POBs).

II. RECOMMENDATION

PROVIDE direction to staff on Pension Obligation Bond.

III. ALTERNATIVES

TAKE another action deemed appropriate by City Council.

IV. BACKGROUND

Per Mayor's request, this report provides background information and funding scenarios to pay down the unfunded actuarial liability (UAL) for the City of Carson PERS plan.

The City has 1 PERS plan: Miscellaneous Plan that includes all full-time employees and some part-time staff. As of July 2019, the plan was 64.8% funded.

The City's UAL plan is comprised of multiple "amortization bases, which are positive and negative amounts generated each year based on the performance of the PERS Investment Fund and changes in the actuarial assumptions as shown in Exhibit 1. Each amortization base has a separate payment schedule over a fixed period of years.

CalPERS payments continue to increase each year. The chart on Exhibit 2 shows the existing UAL payments provided by PERS in its June 30, 2019 report. The chart on the Exhibit 2 also shows that the UAL payment for Fiscal Year 2020-2021 is $7.8 million. This is $1.2 million increase compared to last year's payment.

The City's financial advisor created a number of POB repayment structures for the City Council to consider. Since the majority of the UAL is repaid in 26 years, there is an option presented (Exhibit 3) that shows level debt service through 2038 (19 years) and then debt service declines in proportion to the existing UAL payment schedule shown in the chart above. A second option (Exhibit 4) shows paying a portion of the UAL to achieve approximately 90% funding instead of the 100% funding by prepaying all the amortization basis.

Unfortunately, by prepaying just a portion of the UAL, the same level of savings is not achieved compared to the other options, mostly because the City has to select specific amortization bases to fund with the bonds, and that does not produce a proportionate reduction in annual payments because not all amortization bases are paid off at the same rate.

In all cases, there will be no savings from issuing a POB in Fiscal Year 2019-2020. However, there will be savings going forward. The first interest payment on the new POB would be approximately $6.9 million in 2020-2021 (compared to $7.8 million UAL payment). Therefore, the net UAL saving is approximately $840,842 after the Fiscal Year 2020-2021 payment.

Staff will need to contract with an actuarial analyst to perform a pension obligation risk assessment. Staff also recommends that the City Council create an ad-hoc committee that will assess the risks and make final recommendations to Council regarding the issuance of POB.

To issue bonds, the City would need to assemble a financing team comprised of a financial advisor, bond counsel, underwriter(s), underwriter's counsel, and a trustee. The fees paid to the financing team comprise the costs of issuance, including the underwriter's discount. Costs of issuance approximate 1.5%-2.0% of the amount financed. There are two options for the City to consider in issuing the Bonds.

The City could utilize the California Statewide Communities Development Authority (CSCDA) to issue debt. CSCDA was created in 1988, under California's Joint Exercise of Powers Act, to provide California's local governments with an effective tool for the timely financing of community-based public benefit projects. CSCDA already has a financing team that includes:

- Urban Futures, Inc. as financial advisor;
- Orrick, Herrington & Sutcliffe LLP as bond counsel;
- Stifel as underwriter;
- Stradling Yocca Carlson & Rauth as underwriter's counsel; and
- Wilmington Trust, N.A. as trustee.

CSCDA offers pooled financing that allows multiple agencies to share the costs of issuance. At this time, there are no other agencies in the application pipeline and CSCDA would likely issue stand-alone debt for the City. Using this option, the City could issue debt within about 5 months of submitting an application to CSCDA.

The City could also issue bonds directly, without assistance from CSCDA. Based upon the City's purchasing ordinance, staff would need to solicit competitive proposals for the financial advisor and underwriter. Staff presumes the City would choose to utilize the City Attorney's Office as bond counsel. Including the time to assemble a financing team and award contracts to the consultants, debt could be issued within about 6 months.

If the City issues bonds directly, following the purchasing ordinance and soliciting competitive proposals for the financing team will enable the City to get competitive pricing, high quality services and assure transparency. Staff has already been contacted by four financial advisors and one underwriter regarding a potential bond financing.

POB Cautions

There are criticisms of POBs by the Government Finance Officers Association (GFOA) shown in the Exhibit 5. There will also be future UAL basis created every year in the future to consider. That is, by funding the current UAL at 100%, it does not mitigate all future UAL. For example, this analysis does not take into account the new UAL amortization base that will be created when PERS calculates the cost of potential changes of the discount rate from 7.0% to 6.0%. If CalPERS makes the adjustment, the amount will be reflected in the City's June 30, 2020 PERS report and is expected to add a new amortization basis that will require funding over 20 years.

One of our financial advisors, Harrell & Company,LLC, has addressed the GFOA concerns in the attached Pension Obligation Funding Memo (Exhibit 6). The two most significant risks included in the GFOA's analysis are that (1) the invested POB proceeds might fail to earn more than the interest rate owed over the term of the bonds, leading to increased overall liabilities for the government and (2) POBs are frequently structured in a manner that defers the principal payments or extends repayment over a period longer than the actuarial amortization period, thereby increasing the sponsor's overall costs.

The issuance of the POB and prepayment of the UAL should not be considered an investment vehicle; rather, it is a debt management tool and a way to convert the PERS payments into a more manageable payment structure. The interest rate differential between (1) what PERS is charging the City on its UAL and (2) what the City's POB borrowing costs are, is what provides the basis for creating the cashflow benefit. However, if PERS consistently fails to earn at least as much as the bond interest rate, the ultimate cost of funding the current $104,983,369. UAL may increase.

The Core Risk

The essential risk of POBs is that the invested proceeds will not over time yield an average return in excess of the borrowing rate. A low borrowing rate (say 4% or less) makes this risk very low. That being said the risk exists and the return on pension assets will be unknown for the life of the bond issue. This is one of the valid concerns raised by pension bond critics.

Another key point that needs to be highlighted is that every pension plan is exposed to that market risk. In fact, should CalPERS investment returns average less than 4% for the next twenty or thirty years, every participating public agency would see its unfunded liability balloon and its rates increase dramatically. That would hold for agencies across the board including the City of Carson regardless of whether Council had chosen to issue POBs.

In particular, we can’t ignore the enormous market timing risk of pension bonds, the lack of flexibility with bonds compared to alternative strategies such as increasing contributions to CalPERS, and that issuing the fixed bonds would likely mean even bigger cuts to services in the event of a large downturn in revenues (which is probably going to be correlated with bad investment returns from CalPERS, compounding the problem).

Using POBs to fund a pension plan shifts the risk/reward slope. Should the rate of return be less than the bond rate the City will have a greater overall pension cost (CalPERS plus bond payments) than would have been the case. Conversely, should the rate of return exceed the bond rate, the total pension cost would be lower.

Other Considerations

The following is a summary of other considerations:

- The CalPERS UAL has a “softer” quality than a third party debt obligation. POBs remove some of the potentially flexibility with a more immutable bond obligation.

- POBs result in payment to and investment by the pension fund of a lump sum amount that otherwise would have been paid and invested in increments over a period of years, concentrating rather than spreading market timing risks.

- Almost all POBs are taxable and most taxable bonds with fixed interest rates are sold as non-callable bonds. Therefore, taxable non-callable bonds may be expensive to refund or defease.

Next Steps

If the City Council chooses to move forward with POB, the next steps would include staff recommendations of a pension obligation risk assessment report and the creation of an ad-hoc committee that will assess these risks and make a final recommendations to Council regarding POB.

V. FISCAL IMPACT

Pension bonds “refinance” an agency’s unfunded liability to its pension plan that otherwise is being amortized over time at the plan’s assumed actuarial rate of return. For CalPERS that rate is currently 7%. Debt to the pension plan is replaced with POBs at a lower rate and the proceeds are deposited with CalPERS. Assuming the plan meets its earnings target, the cost of repaying the debt will cut the overall cost of meeting the cost of funding employee benefits.

In its simplest form, issuing pension obligation bonds (POBs) to fund the UAL exchanges one outstanding UAL that has a higher implicit interest rate for the new bonds (POB) that accrues interest at a lower rate. It is only when the structure of each bond is looked at that we can come to a conclusion about the financial benefit to the City of such an undertaking.

As described in this report, while there are many options for selecting which portions of the existing UAL to fund and how to structure the POBs in term of maturity and amortization, the decision to reduce the UAL by issuing POBs will have a positive impact on the City’s cashflow in the short term and, under the best of circumstances, is expected to provide a cost benefit for funding the UAL to the City over 30 years. The consulting costs to issue the bonds (financial advisor, underwriter and bond counsel) are contingent on a successful bond issuance and payable from bond proceeds.

The expected bond issue is approximately $108 million. This structure has the potential savings to the City of an estimated $45 million dollars compared to the PERS payment schedule, assuming that the discount rate and the investment rate are equivalent in future years (risks related to this are discussed later in attached financial report).

VI. EXHIBITS

1. Schedule of amortization base (pg. 6)
2. Projected UAL payment requirements (pg. 7)
3. Level debt service to 2038 then declining to Maturity in 2044 (pg. 8)
4. Partial Funding (pg. 9)
5. Government Finance Officers Association - Advisory on Pension Obligation Bond (pg. 10)
6. Financial Advisor Memo on PERS Unfunded Actuarial Liability (pgs. 11-26)

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