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Title: Consider the Issuance of Pension Obligation Bonds for Long-Term CalPERS Pension Liabilities and Adopt a Pension Policy (Finance Director Charelian).
APPROVE

Sponsors:

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Attachments: 1. Finance Subcommittee Report (September 26, 2019), 2. Finance Subcommittee Report (July 6, 2020 and July 22, 2020), 3. Draft Pension Policy (July 22, 2020), 4. PowerPoint Presentation (October 6, 2020)

Date	Ver.	Action By	Action	Result
10/20/2020	1	City Council Regular Meeting		

TO:
Honorable Mayor and Members of the City Council

THROUGH:
Bruce Moe, City Manager

FROM:
Steve S. Charelian, Finance Director
Henry Mitzner, Controller
Libby Bretthauer, Senior Financial Analyst
Julie Bondarchuk, Senior Accountant

SUBJECT:
Consider the Issuance of Pension Obligation Bonds for Long-Term CalPERS Pension Liabilities and Adopt a Pension Policy (Finance Director Charelian).
APPROVE

RECOMMENDATION:

The Finance Subcommittee and staff recommend that the City Council approve the issuance of Pension Obligation Bonds (POBs), and adopt a Pension Policy. Staff further recommends issuing POBs at 100% of the UAL at the time of issuance (currently estimated at \$91.5 million) to yield the highest present value savings and take advantage of historically low borrowing rates.

FISCAL IMPLICATIONS:

Paying at least the interest due on the City's CalPERS Unfunded Actuarial Liability (UAL) of an estimated \$91.5 million is a priority for the City; otherwise, the UAL balance will continue to grow. Issuance of Pension Obligation Bonds can save the City up to \$31,800,000 (present value) in pension amortization cash payments over the next 25 years. The savings is calculated by taking the

difference between making amortization payments to CalPERS compared to debt service payments over the same period.

BACKGROUND:

The City provides retirement benefits to its employees by contracting with the California Public Employees' Retirement System (CalPERS). CalPERS offers a defined benefit plan where retirement benefits are based on a formula, rather than contributions and earnings to a savings plan. Retirement benefit formulas are calculated based on an employee's years of service credit, age at retirement, and final compensation, which is determined by an employee's average salary, excluding overtime, for a defined period of employment. Retirement formulas for employee groups vary based on classification (Miscellaneous or Safety), and within these groups, by date of entering CalPERS membership ("Classic" or "PEPRA" if entered into CalPERS after January 1, 2013).

Retirement benefits are funded by contributions from both employees and the City ("normal" annual service costs) as well as investment earnings. 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. When investment earnings do not meet expectations over extended periods, the funded status of the entire retirement system is at risk with all member agencies sharing the burden.

CalPERS actuaries perform annual evaluations of the plan to determine the accrued actuarial liability (i.e. defined benefits that will be owed in the future) for each member agency. The accrued actuarial liability is determined by discounting future benefits payable using a rate equal to the expected long-term earnings rate of CalPERS investments. The accrued actuarial liability is inversely related to the discount rate as a lower discount rate will result in a higher accrued actuarial liability.

The funded status of the plan is determined by the difference between the accumulated financial assets of the plan (fiduciary position) and the accrued actuarial liability. If the fiduciary position is less than the accrued actuarial liability, the plan is underfunded, and an Unfunded Actuarial Liability (UAL) exists. Employers have the sole responsibility to pay down their UAL by increasing contributions since the accrued benefits earned by an employee/retiree may not be reduced per California law.

According to the latest analysis from the City's CalPERS Actuary, which was released in July 2020, the City's UAL for all employee groups across all funds is projected to be \$91.5 million as of June 30, 2021. The City's plans are currently 73 percent funded.

The discount rate (currently at 7%) signifies CalPERS' assumed return on investments and is used by CalPERS actuaries to calculate the UAL. In the event that CalPERS reduces the current discount rate, all agencies in CalPERS will be impacted by higher liabilities and, consequently, required payment contributions.

When CalPERS last reduced its discount rate, causing employer liabilities to significantly increase, CalPERS implemented a "ramp up" strategy to smooth out the increases in UAL contributions. As opposed to a fixed-level payment schedule, CalPERS started using a 25 year amortization schedule where payments are ramped up in the beginning years and ramped down in the ending years. For agencies wanting to accelerate the payoff of their UAL, CalPERS allows additional discretionary payments at any time.

Similar to bonded debt or a mortgage, the UAL is "amortized" (i.e. gradually reduced or paid off with regular payments covering principal and interest) over a period of time. To calculate the interest cost

of the City gradually paying down its outstanding UAL of \$91.5 million, the UAL is multiplied by the discount rate. At the current discount rate of seven percent, the implicit interest cost in Fiscal Year (FY) 2020-2021 is roughly \$6.4 million. By accelerating payments to CalPERS, the City will be paying down the principal balance of the UAL, thereby saving on interest costs.

DISCUSSION:

As of July 2020, the funded status of all City of Manhattan Beach retirement plans is currently estimated at 73 percent. The City's unfunded actuarial liability (UAL) will be approximately \$91.5 million as of June 30, 2021 (CalPERS most recent return on investments of 4.7 percent for the fiscal year ended June 30, 2020, will be factored into next year's valuation report).

This demand on City resources over the next 20-25 years will need to be balanced with liquidity needs for ongoing City operations, community priorities, and long-term infrastructure needs. Staff analyzed various options to reduce the UAL, while preserving the City's fiscal integrity, with the following goals in mind:

- Preserve financial flexibility to meet or maintain City service obligations while funding pension benefit obligations.
- Consistent with the Government Finance Officers' Association (GFOA) recommendations, strive to repay or amortize unfunded pension liabilities over a period not-to-exceed 20 years (ideally fall in the 15-20 year range, but never exceed 25 years).
- Shorter amortization periods dramatically reduce interest costs and better matches the cost with the work-life of plan participants (i.e. equitable allocation of cost among generations).
- Pay at least the interest owed on the UAL to avoid negative amortization which ultimately increases UAL and interest costs.
- Introduce a level dollar repayment schedule to improve the likelihood that funds will be available to meet future payment demands. A level dollar payment plan becomes a decreasing percentage of the annual budget over time, whereas an increasing dollar payment plan moves in a commensurate manner with rising budgets. Level dollar repayment plan also helps facilitate the budget process and long-term financial planning.

With these funding goals in mind, staff made recommendations on paying down the City's UAL during the September 26, 2019, FSC meeting. One option was to make additional discretionary payments to CalPERS to lower principal and remove negative amortization. The FSC directed staff to research issuing POBs. At the July 6, 2020, FSC meeting, staff brought back options to issue POBs for the City's UAL between 80%-100%. At the July 22, 2020, meeting, the FSC approved a Pension Policy and directed staff to bring forward to City Council the consideration of POBs with the best financing option available at a percentage less than 100%. Upon further review, staff is recommending that the Council authorize issuance of POBs in an amount equal to 100% of the then-current UAL in order to take advantage of historically low interest rates and maximize cost savings.

These funding goals formed the basis of the funding options and recommendations discussed with the Finance Subcommittee on September 26, 2019, and more recently on July 6 and July 22, 2020. From the initial report in 2019, municipal borrowing rates have fallen dramatically, making the cost of

borrowing more attractive than the seven percent interest rate currently assessed by CalPERS. The Finance Subcommittee (FSC) discussed current market conditions and Pension Obligation Bond funding options. As a result, the FSC voted to recommend funding the CalPERS pension liability using the best financing option available and directed staff to prepare a report for full City Council approval.

Staff also contracted with Bartel Associates, LLC for actuarial services to independently evaluate the City's UAL position under a variety of discount rates and financial return scenarios. These different scenarios enable the City to develop a long-term financial plan and budget depending on future anticipated outcomes. Bartel Associates provides more updated actuarial information which is not available from CalPERS.

City staff has also been in contact with our CalPERS actuary regarding the impact of issuing POBs. Assuming POBs are issued by April 2021, CalPERS will recalculate the required UAL payment for FY 2021-2022 that was originally calculated in the actuarial report issued in June 2020. In addition, our next actuarial valuation reports will reflect the payment of bond proceeds in April 2021 and factor this into our FY 2022-2023 required UAL payment. The required UAL payment will depend on the amount contributed from bond proceeds.

At the October 6, 2020, City Council meeting staff presented the consideration of the issuing of POBs for long-term CalPERS pension liabilities and pension policy. To allow additional time for inquiries City Council requested staff to bring back the item to the October 20, 2020 Council meeting.

PENSION OBLIGATION BONDS

Pension Obligation Bonds (POBs) are one option to address budgetary impacts from rising UAL contributions. A POB is a taxable debt issuance used to pay some or all of a public agency's UAL. The bond proceeds are deposited with CalPERS to reduce the City's UAL. Debt service payments for the bond issuance will then replace the City's UAL payments that would have been owed to CalPERS for the UAL amount that was paid off.

Issuing POBs removes an unknown variable cost and replaces it with a stable, fixed payment amount. POBs should only be issued when the all-in interest rate of the bond issue is significantly below the actuarial rate of interest factored into the calculation of the UAL. KNN Public Finance, the City's Municipal Advisor, has estimated the City's cost of borrowing to be 3.1%, which is well below CalPERS' discount rate of seven percent. With this criterion met, the amount of the POB is the next consideration.

A prudent objective is to fund pension plans near 100% of the total accrued liability and no less than 80%, whenever possible. For this reason, staff reviewed options for issuing POBs at various payoff percentages of the UAL.

100%	\$91.5 million for Present Value Savings of \$31.8 million
90%	\$82.4 million for Present Value Savings of \$28.6 million
80%	\$73.3 million for Present Value Savings of \$25.3 million

To achieve the most savings for the City, staff recommends issuing POBs at 100% of the current UAL. If CalPERS does not achieve their annual discount rate of seven percent returns, then the City's UAL will increase and create new UAL. In the event that CalPERS exceeds the seven percent annual return, then the City's UAL could potentially be reduced. While issuing POBs at 100% of our

UAL yields the most savings, there is also a potential risk in stranding our assets by paying off 100% of the UAL (CalPERS will not return excess assets to the public agency if overfunded).

With the issuance of POBs, the adoption of a Pension Policy is strongly recommended to memorialize how the City intends to use the budgetary savings that will result from the issuance of the bonds. On July 22, 2020, the Finance Subcommittee approved the attached Draft Pension Policy, including the proposed plan for the use of budgetary savings.

Several cities throughout California have recently issued, or are in the process of issuing bonds. Cities who have recently issued bonds include Pasadena, Glendora, West Covina, Montebello, Ontario, Carson, and Riverside. A partial list of cities in the process of exploring bonds include Huntington Beach, Orange, Gardena, and Hawthorne.

PROJECTED SAVINGS

If the City issues POBs near 100% of the UAL, the projected budgetary savings over the next ten years ranges from \$1.2 million to \$4.5 million annually. The attached Draft Pension Policy aims to memorialize how the City plans to utilize the budgetary savings. The Draft Pension Policy recommends allocating the budgetary savings as follows: 40%-60% will be used to offset any future UAL costs that arise and 40%-60% will be used to offset General Fund operational costs.

Staff recommends including ranges within the Pension Policy to provide the City Council some flexibility when preparing the budget for each new fiscal year. However, during the Budget process each fiscal year, a recommendation for the precise savings allocation will be determined based on CalPERS' latest year-end investment return. For example, if CalPERS' fiscal year-end investment return is below its benchmark, the City Council may choose to allocate a higher portion of savings to fund future UAL costs. Alternatively, if CalPERS' fiscal year-end investment return is higher than its benchmark, then the City Council may choose to allocate more of the budgetary savings to offset General Fund operational costs or reserve those funds for future, non-enterprise, capital projects (CIP Fund).

A fundamental consideration in choosing a pension payment savings plan is the effect on the General Fund, since the General Fund accounts for about 94 percent of all pension contributions. The options must be weighed with balancing liquidity needs and longer-term goals.

If City Council approves moving forward with the POBs, the next step will be to bring a Resolution and Indenture to the City Council meeting in December. The Indenture will identify the specific terms of the bond issuance, maximum bond amount, interest rate and a framework for the validation process.

PUBLIC OUTREACH:

The City's Finance Subcommittee discussed the topics in this report at their public meeting on September 26, 2019 as well as more recently on July 6, 2020, and July 22, 2020. This item was also presented at the October 6, 2020 City Council meeting. To allow more time for public questions, City Council asked to bring back the consideration of issuing POBs and the Pension Policy to the October 20, 2020 Council meeting. Agendas for the Finance Subcommittee and City Council public meetings are posted in advance on the City's website at <https://www.cityymb.info>.

ENVIRONMENTAL REVIEW:

The City has reviewed the proposed activity for compliance with the California Environmental Quality

Act (CEQA) and has determined that the activity is not a “Project” as defined under Section 15378 of the State CEQA Guidelines; therefore, pursuant to Section 15060(c)(3) of the State CEQA Guidelines the activity is not subject to CEQA. Thus, no environmental review is necessary.

LEGAL REVIEW:

The City Attorney has reviewed this report and determined that no additional legal analysis is necessary.

ATTACHMENTS:

1. Finance Subcommittee Report (September 26, 2019)
2. Finance Subcommittee Report (July 6, 2020 and July 22, 2020)
3. Draft Pension Policy (July 22, 2020)
4. PowerPoint Presentation (October 6, 2020)