# City of Escondido
# Pension Obligation Bond Workshop

May 25, 2022

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# Overview of Presentation

- Overview of CalPERS
- Review the Unfunded Accrued Liability (UAL)
- What are Pension Obligation Bonds?
- Recent Pension Obligation Bonds issued in San Diego County
- Next Steps

# Overview of CalPERS

Most cities in California, including Escondido, contract with **CalPERS** for their employees' retirement benefits

- CalPERS provides for and manages the City's employee pension plans

Escondido has two Plans with CalPERS:

**Safety Plan** – Sworn Police and Fire Employees

**Miscellaneous Plan** – All Other Employees*

*General Fund, Water, Wastewater, Internal Service & Special Revenue Funds

# Overview of CalPERS

Every year, the city and employees contribute to CalPERS to pay for future retirement benefits.  The City makes two types of payments to CalPERS:

– **Normal Cost (NC)**

Annual cost for current employees

– **Unfunded Accrued Liability (UAL)**

Actuarial Liability MINUS Actuarial Value of Assets

# Overview of CalPERS

| Member Type | Safety | Miscellaneous | Total | Member Type Description |
|---|---|---|---|---|
| **Active** | **245** | **566** | **811** | Current employees enrolled in CalPERS |
| **Transferred** | **60** | **336** | **396** | Former employees that are employed at another CalPERS employer |
| **Separated** | **55** | **409** | **464** | Former employees that are not working at another CalPERS employer and are not retired |
| **Retired** | **344** | **755** | **1,099** | Former employees that are now retired from the CalPERS system |
| **Total** | **704** | **2,066** | **2,770** | |

*Source: CalPERS Actuarial Valuation Report as of 06/30/2020 (most recent available)*

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# Unfunded Accrued Liability Calculation

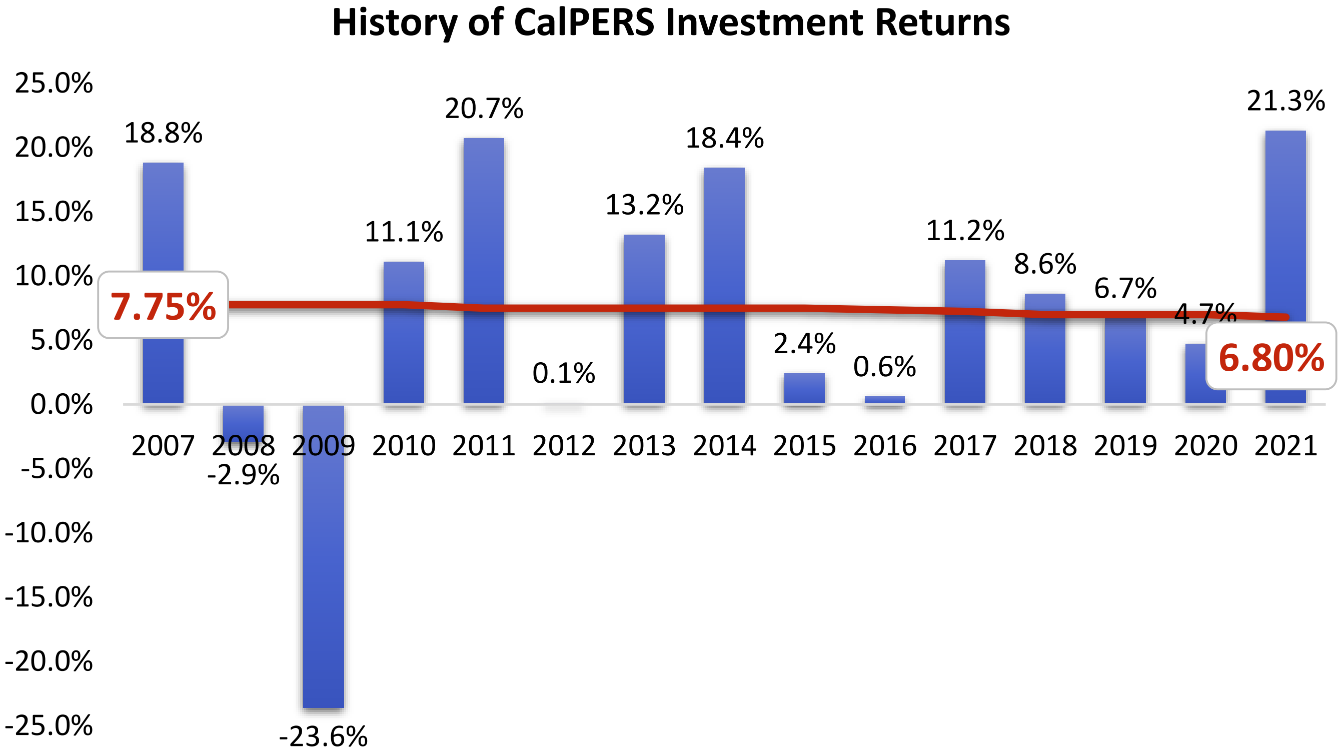
**The UAL is the difference between the City's retirement plan assets and the amount that will be needed to be paid as a retirement benefit to members**

| | Safety | Miscellaneous | Total |
|---|---|---|---|
| CalPERS Accrued Liability | $434,370,502 | $459,862,821 | $894,233,323 |
| Market Value of Assets (MVA) | $309,037,732 | $318,091,829 | $627,129,561 |
| **Unfunded Accrued Liability (UAL)** | **$125,332,770** | **$141,770,992** | **$267,106,762** |
| Funded Ratio | 71.2% | 69.2% | 70.1% |

- **Safety Plan: Funded by the General Fund**
- **Miscellaneous Plan: Funded by the General Fund, Water, Wastewater, Internal Service & Special Revenue Funds**

# Unfounded Accrued Liability Calculation

*Historically, more than 60% of all funds paid to CalPERS retirees comes from investment earnings.*




**Discount Rate**

the estimated long-term average return expected to be earned on investments.

**As a result of reductions in the discount rate, the City is required to contribute more each year.**

# Annual Unfunded Accrued Liability Payments

*Annual payments up to $28M until FY2043/44*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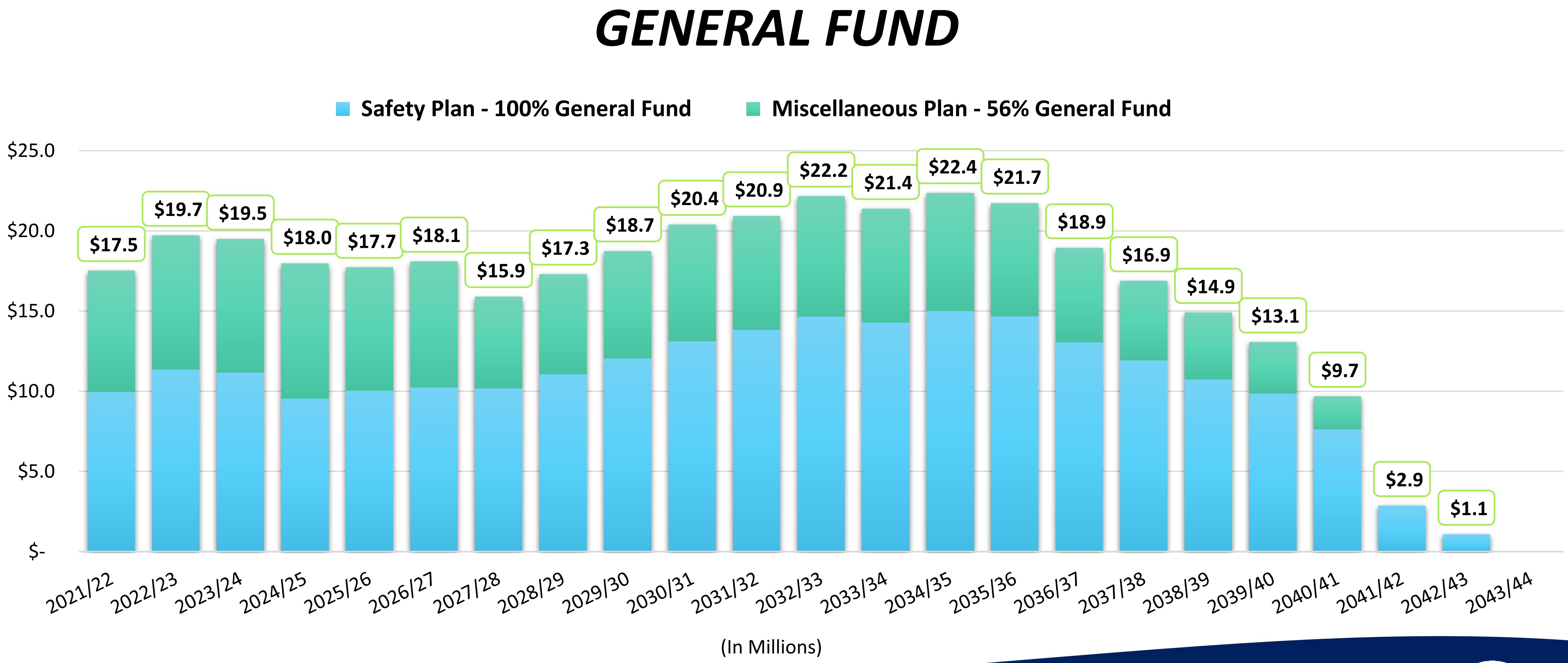
# Annual Unfunded Accrued Liability Payments

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# Pension Obligations

*In January 2018, the League of California Cities published a study on the CalPERS Retirement System and listed options that Cities may consider to address growing pension liabilities:*

### New Sources of Revenue

Create new sources of revenue to help defray the costs of the City's pensions

### Section 115 Trust

Allocate reserves to help stabilize yearly fluctuations in pension rates.

**City established in February 2018**

✓

### Capital Reserves

Using cash reserves to make additional payments to CalPERS

### CalPERS Fresh Start

Consolidate amortization bases and reshape payments to be paid off over a shorter period. ***This would result in higher annual UAL payments***

### Pension Obligation Bonds

Restructure the UAL at a lower interest rate

# What are Pension Obligation Bonds?

*Taxable form of debt issued by governmental employers to retire all or a portion of their Unfunded Accrued Liability ("UAL") with the goal of reducing future liability*

**The overall strategy of POBs is to achieve interest rate savings**

The UAL with CalPERS has an effective interest rate of 6.8%

Depending on the bond interest-rate market & the City's rating & size, POBs can be issued at a rate less than 6.8%.

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# What are Pension Obligation Bonds?

The POB debt service payments to investors would replace the City's UAL payments to CalPERS.

– The proceeds from the POB issuance are remitted to CalPERS and will <u>temporarily</u> eliminate all or a portion of the City's UAL with CalPERS.

- The City can never permanently eliminate the UAL as changes in investment returns, actuarial assumptions, and other factors could create a UAL in the future.
- Payments still owed to CalPERS:
  - 100% of Normal Cost payments for current employees
  - Remaining UAL payments not funded with POBs
  - Any future UAL payments

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# What is a Pension Obligation Bond?

| Unfunded Accrued Liability | Pension Obligation Bond |
|---|---|
| – City owes $267M to CalPERS | – City owes $267M to investors |
| – City pays the discount rate, 6.8% | – City would pay the bond rate |
| – City pays an adjustable interest rate that can vary in the coming years | – Bond rate is a fixed interest rate that does not change for the term of the bonds |
| – New UAL can be added if CalPERS' assumptions change or future interest earnings are below the discount rate | – New UAL can be added if CalPERS' assumptions change or future interest earnings are below the discount rate |
| – Final Payment is 2043 | – City can modify to meet its objectives |

# Why Pension Obligation Bonds?

**POBs may represent part of a solution to the City's pension liability**

- Historically low interest rates in 2021, especially in relation to the CalPERS discount rate have made POBs more attractive

**POBs are a tool with certain benefits and risks**

- POBs can create an amortization schedule that is more predictable by making payments level and may be used to create near term savings
- POBs are not a refinancing used to generate savings in the classic public finance context
  - The actual "savings" realized will depend on CalPERS investment earnings and future changes to the discount rate

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# Pension Obligation Bonds – Key Benefits

**Fiscal Sustainability Tool**

- Ability to restructure City's pension payments in a way that creates enhanced long-term fiscal sustainability that lowers costs and increases budget certainty

**Near-Term Budgetary Savings**

- By addressing the peak in scheduled payments to CalPERS and creating more level payments, City may be better able to manage their pension obligations

**Interest Rate "Savings"**

- Issuing POBs at market rates that are lower than what CalPERS charges on the UAL creates interest savings through arbitrage

**Modify Maturity**

- City has flexibility to shorten or lengthen repayment period to meet financial and policy objectives

**Reserves/Services**

- UAL restructuring may reduce need to draw on reserves or reduce services

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# Pension Obligation Bonds – Key Risks

**Turning a "Variable" Obligation Into a "Fixed" Obligation**

- POBs turn the UAL liability payment due to CalPERS into an obligation due to investors.
- Either way, the obligation is owed, but a city may have more flexibility in working with CalPERS to sort out payment problems than with bond investors.

**Low Pension Fund Returns**

- Earnings below the discount rate means the UAL is increased with a new amortization base. The earnings shortfall applies to the Market Value of Assets, which is higher due to the POB issuance. The resulting new amortization base will therefore be larger.

**"Too Much of a Good Thing"**

- If after a POB issuance, CalPERS consistently returns more than 6.8% (the discount rate), the City's pension plan could become super-funded and it wouldn't be able to retrieve the surplus from CalPERS while still paying POB debt service.

# Pension Obligation Bonds – Key Risks

**Future UAL Can Still Change**

- Future UAL will change whether or not a POB is issued: depends on earnings, changes to the discount rate or revision of underlying assumptions

**Increased Bonded Debt**

- POBs increase bonded debt load while reducing the UAL

**Validation Process**

- Issuance of POBs is subject to a judicial validation filing which may be challenged in Court proceedings
- Validation establishes a city's ability to issue POBs as an "obligation imposed by law" not subject to further voter approval as "debt" or the constitutional debt limit

**Political Process**

- Key stakeholders, constituents and interest groups may be critical of using POBs as instrument to address the pension challenge

# POBs issued by other CA Cities

*Approximately 36 Cities in the State have issued POBs since 2019 – 3 Cities in San Diego County*

- Arcadia
- Auburn
- Azusa
- Baldwin Park
- Carson
- Chowchilla
- **Chula Vista**
- Coachella
- Corte Madera
- Covina
- Downey
- **El Cajon**
- El Monte
- El Segundo
- Gardena
- Glendora
- Grass Valley
- Hawthorne
- Huntington Beach
- Inglewood
- Larkspur
- Manhattan Beach
- Marysville
- Montebello
- Monterey Park
- Ontario
- Orange
- Pasadena
- Placentia*
- Pomona
- **Poway**
- Redondo Beach*
- Ridgecrest
- Riverside
- Torrance*
- West Covina*
- Willows

* Structured as a Lease Revenue Bond.

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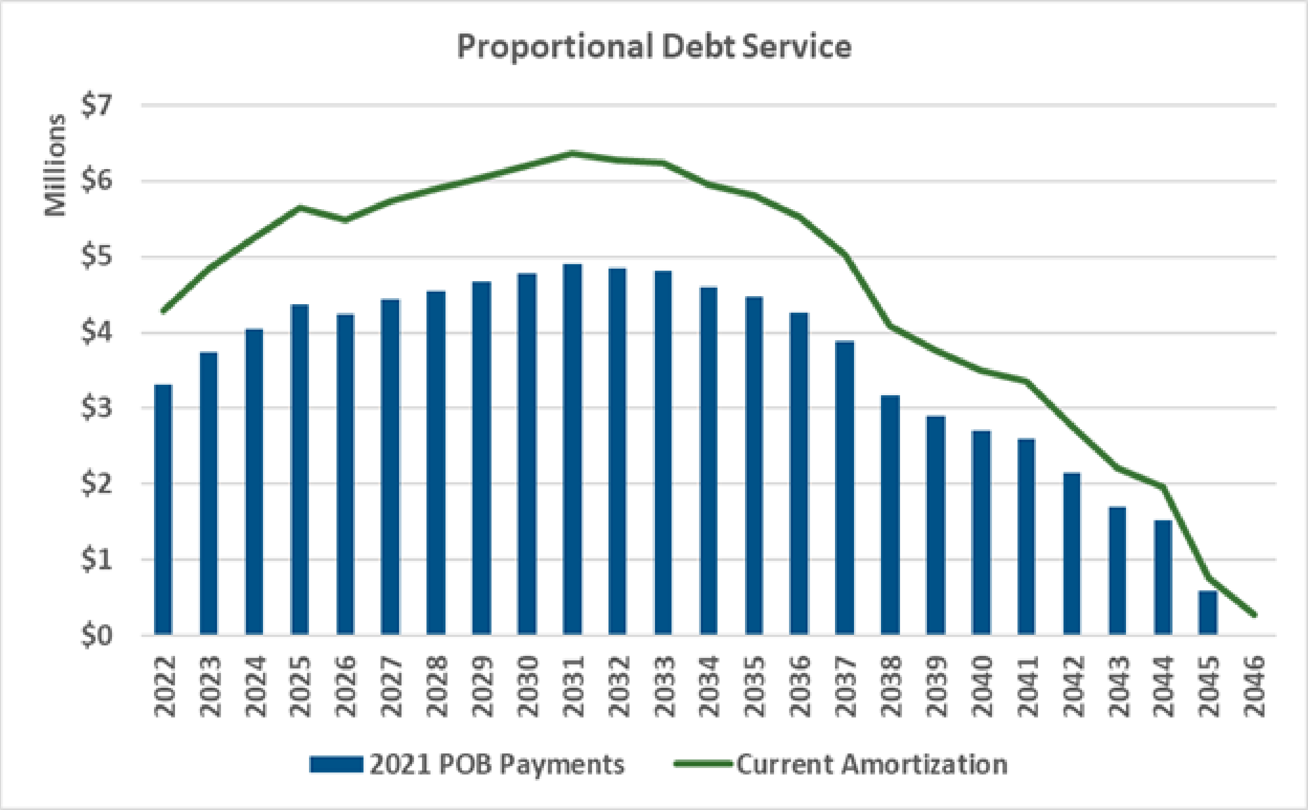
# POB Structuring Examples

*City of Poway - Issued January 2022*




## Proportional Debt Service

Debt Service Payments mirror the City's current UAL payment schedule

- Bond Issuance Amount $61.5 Million
- Average annual savings of $1.0 Million

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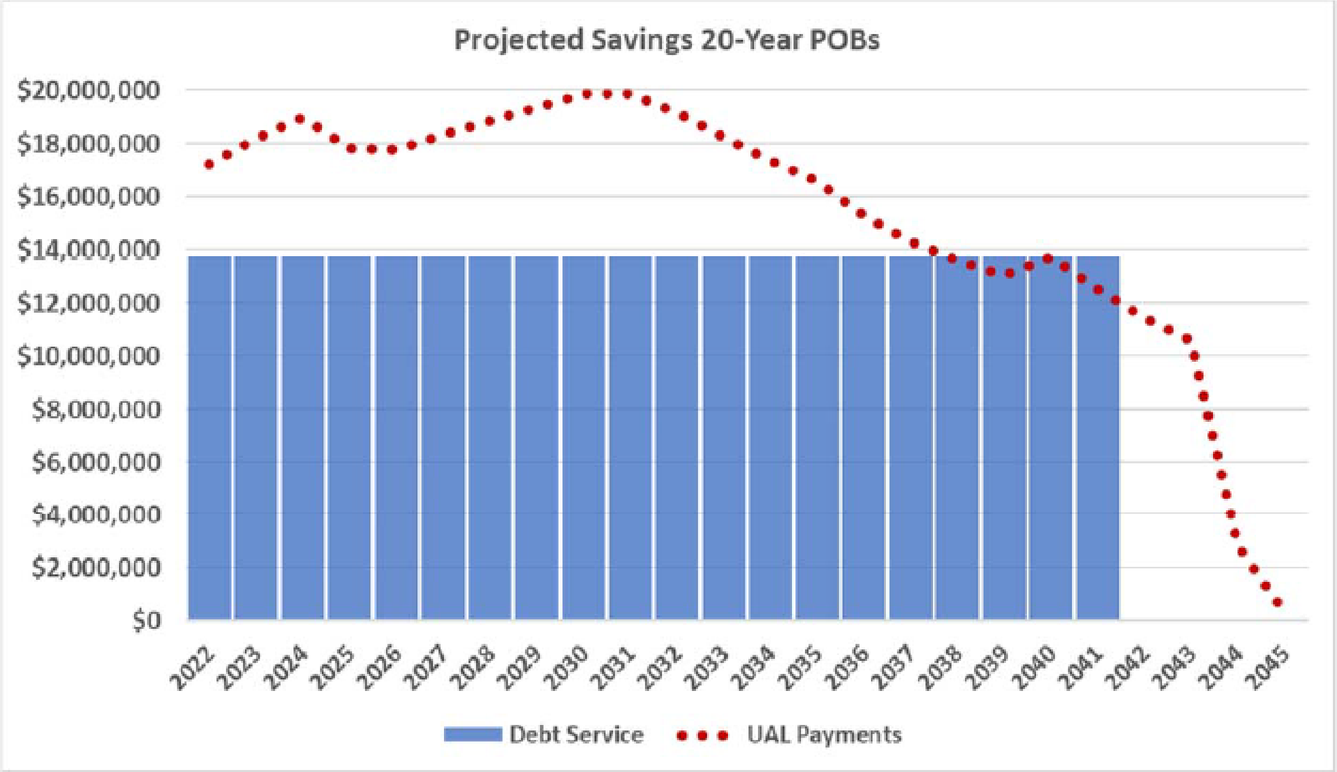
# POB Structuring Examples

*City of El Cajon - Issued January 2021*




**<u>Level Debt Service</u>**

Consistent debt payments for easier budgetary control and financial planning

- Bond Issuance Amount $147.2 Million
- Average annual savings of $3.2 Million

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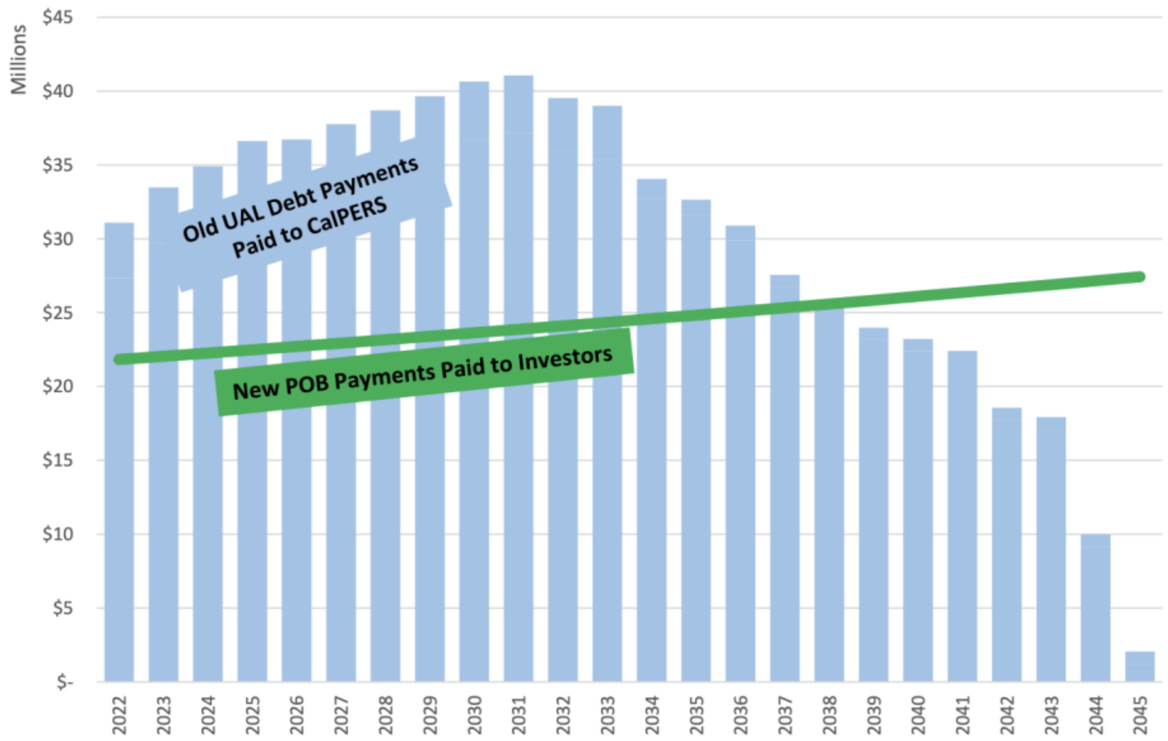
# POB Structuring Examples

*City of* Chula Vista - *Issued January 2021*

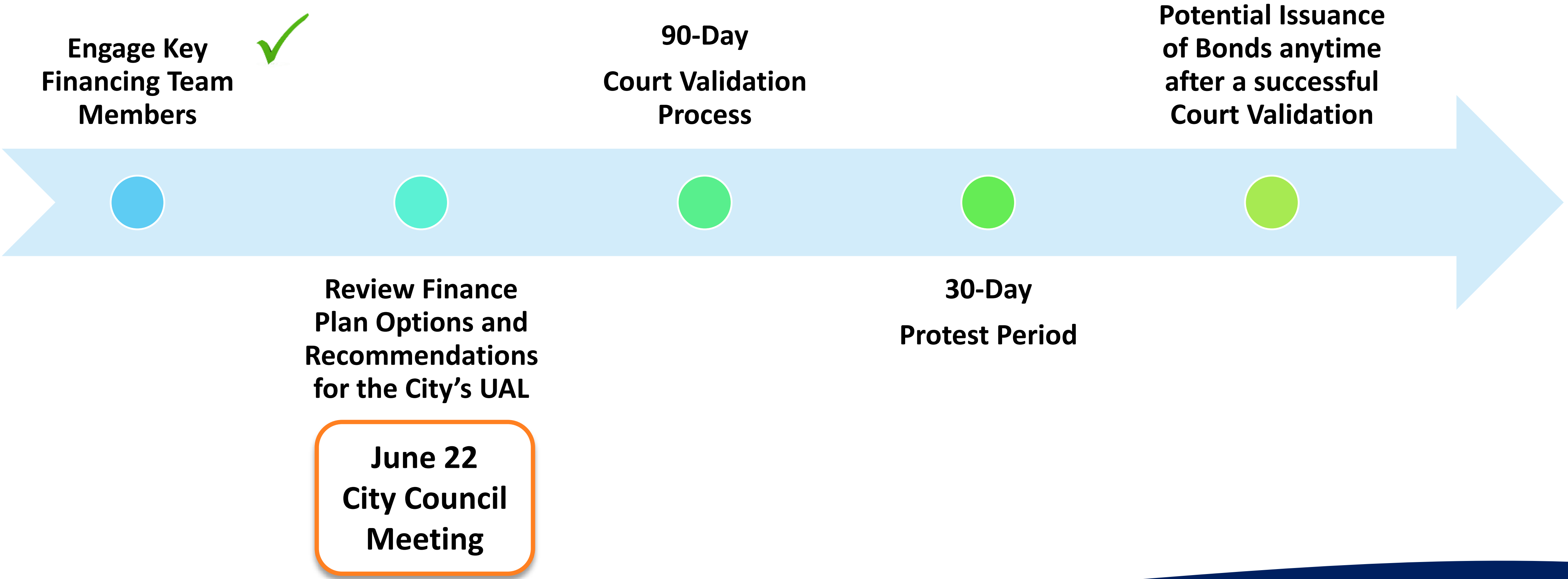



## Escalating Debt Service

Structured the bond payments to wrap around existing General Fund debt service and, in combination, sculpt an aggregate 1% escalating debt service obligation. A pension management policy was adopted to direct early years' savings towards funding reserves.

- Bond Issuance Amount $350 Million
- Average annual savings of $14 Million for the first 15 years

# Timeline for the Issuance of POBs



# Court Validation Process

- POBs fall under an exception to the constitutional debt limit because of a public agency's obligation to fund its pension system payments.
- POB documents are "validated" in Superior Court
  - **Validation does not obligate the City to issue bonds, nor even to have agreed on a specific plan of finance.**
- First step in the validation process is the preparation of bond documents.
  - **The documents can be prepared with maximum flexibility regarding bond structure and terms to position the City to move quickly if it decides to issue POBs at a future date.**

# Next Steps

Return to City Council June 22 with a Risk Analysis, Financing Options, and Recommendation

- Financing consultants will evaluate risks & options
  - Financial Advisor – CSG Consulting
  - Bond Counsel – Stradling, Yocca & Rauth
  - Bond Underwriter – Stifel & Associates

With City Council approval, begin the Court Validation Process

# Questions?