SUBJECT

APPROVAL TO COMMENCE JUDICIAL VALIDATION PROCEEDINGS FOR PENSION OBLIGATION BONDS

DEPARTMENT

Finance

RECOMMENDATION

Request the City Council adopt Resolution No. 2022-89, authorizing judicial validation proceedings relating to the issuance of bonds to refund certain pension obligations of the City, approving the form and authorizing the execution of a trust agreement and bond purchase agreement, and approving additional actions related thereto.

Staff Recommendation: Approval (Finance: Christina Holmes)

Presenters:

Christina Holmes, Director of Finance

Sara Oberlies Brown, Managing Director of Stifel Public Finance

Scott Smith, Principal of CSG Advisors

FISCAL ANALYSIS

The City of Escondido (“City”) and its financing team have evaluated a range of structuring options (various maturities and repayment shapes) which will be presented during tonight’s meeting. The approval of a resolution, draft Trust Agreement, draft Bond Purchase Agreement and approval to proceed with the judicial validation process is the initial step in this effort and will give staff and the financing team direction to continue to analyze a POB issuance for the City.

PREVIOUS ACTION

On January 26, 2022 City Council received information on the City’s California Employees Retirement System pension obligations. On May 25, 2022, a Pension Obligation Bond Workshop was conducted.
BACKGROUND

The City provides retirement benefits to its employees who provide the City services residents rely on, by contracting with the California Public Employees Retirement System (CalPERS). 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. Historically, more than 60% of all funds paid to CalPERS retirees comes from investment earnings. The estimated long-term average return expected to be earned on investments is referred to as the "discount rate". When lower investment earnings occur, future contributions must increase to make up the expected difference and an unfunded accrued liability ("UAL") is created. The UAL represents the shortfall or gap between what is needed to pay retiree benefits versus how much in current assets the City actually has in its accounts with CalPERS. The UAL is calculated annually and changes depending on the demographic trends of the plan participants.

As noted above, the UAL is essentially the City’s debt owed to CalPERS, and CalPERS currently charges the City a 6.8% interest rate on this debt with a mandatory payment schedule. The table below reflects the UAL from the most recent CalPERS actuarial valuation report as of June 30, 2020. CalPERS will release a new Annual Valuation Report as of June 30, 2021 in July/August 2022.

<table>
<thead>
<tr>
<th>City of Escondido UAL Calculation Based on CalPERS 06/30/2020 Valuation</th>
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<tbody>
<tr>
<td>A. Entry Age Normal Accrued Liability</td>
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<tr>
<td>$469,434,960</td>
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<tr>
<td>B. Market Value of Assets (MVA)</td>
</tr>
<tr>
<td>C. Unfunded Accrued Liability (UAL)</td>
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<td>D. Funded Ratio</td>
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Pension cost increases are one of the largest financial challenge facing most cities throughout the state and are primarily due to factors outside of the cities' control, namely actuarial assumption changes made by CalPERS and below average investment returns. CalPERS and the League of California Cities have detailed various options available to help manage pensions. There is no perfect solution to managing a City’s pension obligations and many agencies employ multiple methods to manage their pension obligations. The most typical options include:

1. Identify new sources of revenue to help defray the costs of the City’s pensions,
2. Using cash reserves to make additional payments to CalPERS or to the City's Section 115 Pension Trust Fund to help stabilize yearly fluctuations in pension rates,
3. Pursue a CalPERS Fresh Start which allows an agency to consolidate multiple amortization bases (different components of the UAL) into one base paid off over a shorter period. While annual payments will increase, the UAL can be paid off earlier and it would save the City money over the long-term, or

4. Restructure the UAL at a lower interest rate, such as a Pension Obligation Bond.

**PENSION OBLIGATION BONDS**

A public workshop was held on May 25, 2022. Concepts of a Pension Obligation Bond ("POB") were introduced and the benefits and risk factors associated with a POB were disclosed and discussed. There are several potential benefits the City could realize by issuing POBs. These potential benefits include:

1. A tool for fiscal sustainability,
   POBs provide the ability to alter the City’s UAL payments in a way that could support long-term financial sustainability, help provide budget predictability and minimize the year over year variability in payments, and provide enhanced resiliency to economic shocks.

2. Budgetary savings,
   Using POBs to modify the current CalPERS UAL payment schedule’s peak in projected payments to a more predictable or level structure can create cash flow savings.

3. Interest rate “savings” from arbitrage,
   Issuing POBs at market rates that are lower than what CalPERS charges on the UAL creates interest savings through arbitrage. In this example, arbitrage is created by taking advantage of the difference between the CalPERS rate of 6.8% and current market rates. All else being equal, the City would realize a lower cost of debt.

4. Maturity modification, and
   A POB may have a shorter or longer repayment period based on market conditions and the financial objectives of the issuer. However, if the POBs are structured with deferred principal amortization or repayment longer than the actuarial amortization period the overall cost of debt may increase. Further lengthening the debt repayment period adds risks and is specifically noted in the Government Finance Officers Association advisory against POBs.

5. Preservation of reserve and service levels.
   Potential savings achieved through a POB issuance could reduce the need to use reserves to fund ongoing expenditures or reduce service levels.
There are also many potential risks to consider with a POB:

1. **It turns a “variable” obligation into a “fixed” obligation,**
   The City’s UAL obligation to CalPERS will change year over year. It could increase or decrease based on a variety of factors such as investment returns or actuarial assumption changes. This allows the City to benefit from UAL decreases (i.e. lower payments to CalPERS) but does also mean the City is negatively impacted by increases (i.e. higher payments to CalPERS). Issuing a POB transfers and refinances the obligation due to CalPERS into a fixed obligation due to investors. An obligation due to investors will not increase or decrease over time which can be beneficial under the right conditions as it limits downside risk associated with an increasing UAL. However, it also carries risk as a fixed obligation because it cannot take advantage of a consistently decreasing UAL.

2. **Low pension fund returns,**
   If CalPERS investment earnings are below its current discount rate of 6.8% in a given year, the City’s UAL will increase from the addition of a new amortization base to reflect the investment earnings shortfall. This investment shortfall is applied to the City’s Market Value of Assets (MVA) which will be higher after the issuance of POBs. The new amortization base from the investment shortfall will be larger given the MVA is higher resulting in a larger amortization base than the City would have had before issuing POBs. The City’s funded ratio would still be higher, however.

3. **“Too much of a good thing,”**
   If CalPERS investment returns consistently exceed 6.8% after the City issues a POB, the City’s pension plan could become super-funded (i.e. has placed more money with CalPERS than is necessary to cover its pension obligations). Because the POBs become a fixed obligation, the City would not benefit from these surpluses (required contributions would not decrease as the Normal Cost must always be paid) which means the City loses the benefits of cash it could have used on other city services.

4. **Future UAL can still change,**
   The City will always have some UAL or the potential for some UAL. Issuing POBs does not eliminate the City’s UAL obligations; it merely refinances the City’s UAL obligations as of a point in time. This will occur as a result of things such as CalPERS investment returns, future changes in the CalPERS discount rate, changes in actuarial assumptions, etc.

5. **Market timing risks,**
   Market timing risk is related to the timing of the investment of the bond proceeds. A POB issuance produces a lump sum of proceeds which must be remitted to CalPERS immediately after issuance. This lump sum concentrates market timing risks rather than spreading it. This is especially a consideration in the recent economic environment as equity markets are at all-time highs. If a market crash occurred between the bond sale and CalPERS investment of the bond proceeds,
which is typically two weeks apart, the initial investment cost would be lower and could potentially provide higher future returns. However, if a market crash occurred after the initial investment of bond proceeds, it would negatively impact future earnings given the decreased potential for compounded earnings. It would also likely result in a new amortization base and increase in UAL all else being equal.

6. Increased bonded debt and credit risk,
Issuing POBs would reduce the City’s UAL but increases its bonded debt potentially using up debt capacity that could be used for other purposes. Having more bonded debt may also impact the City’s credit rating. S&P Global Ratings views POBs in environments of fiscal distress or as a mechanism for short-term budget relief as a negative credit factor. That being said, S&P also identifies a large liability to CalPERS as a credit negative and there have been many POB issuers, Chula Vista is a recent example, that did not receive a downgrade in rating associated with the issuance.

7. Judicial validation process, and
The City must proceed through a judicial validation process to issue POBs. POB issuances are validated on the basis that such bonds are an exception to the constitutional debt limit because of a public agencies’ obligations to fund its pension system payments. To date, several public agencies have received a default judgment, but no court has formally ruled on the constitutional debt limit exception.

8. Political process.
POBs can be controversial because, among other things, some view them as gambling on future market returns and they’ve received a negative reputation due to well publicized bankruptcies (Detroit, Stockton, and San Bernardino). Stakeholders, constituents, and interest groups may be critical of using POBs as an option for managing the City’s pension obligations.

The City and its financing team will present preliminary UAL restructuring options to refund 100% of the UAL for both the Miscellaneous Plan and Safety Plan. Under current market conditions, estimated savings on a present value basis are approximately $13.8 million or about 4.6% of the refunded UAL. The annual cash flow or budgetary savings to the City over the next 10 years are approximately $1.2 million. With an approximately 100 basis point (1.0%) improvement in interest rates, the present value savings increase to around $40 million (13% of the refunded UAL), translating to annual cash flow savings over the next 10 years of about $3.3 million. A 150 basis point improvement (1.50%) produces annual savings around $4.3 million. Actual savings achieved will depend on improved market conditions.

The approval of a resolution, draft Trust Agreement, draft Bond Purchase Agreement and approval to proceed with the judicial validation process is the initial step in this process and will give staff and the financing team direction to continue to analyze a POB issuance for the City.
JUDICIAL VALIDATION PROCESS

Authorizing the validation proceeding is the first step in the issuance process; it entails the courts validating the City’s legal ability to issue POBs, and to confirm that the sale meets the State of California’s constitutional requirements. Under normal circumstances, the validation process takes about 4 months to complete. Key milestones of the validation process are listed below:

- City Council passes a resolution authorizing the sale of POBs;
- File validation action with San Diego County Superior Court;
- Receive Order for Publication of Summons from the Court (This can take >3 weeks to receive);
- Publication of notice in local newspaper;
- Waiting period for any responding party to file a petition;
- Clerk enters hearing for a default judgement if there is no responding party, schedules a hearing;
- Hearing for default judgement, if no responding party;
- 30-day appeal period.

Although the issue has not been litigated extensively in California, dozens of prior default (i.e. uncontested) validation judgments have determined that pension liabilities are obligations imposed by law and therefore exempt from the debt limitation requirements set forth in Article XVI, Section 18 of the California Constitution. Staff does not anticipate a judicial validation process for the City will proceed differently.

Resolution: The resolution being approved tonight authorizes staff and outside counsel to submit the necessary documents to the San Diego County Superior Court to start the judicial validation process as well as approves:

(1) the issuance of the bonds in an amount not-to-exceed $350 million,
(2) a draft form of the Trust Agreement for the bonds (Attachment 1),
(3) draft form of the Bond Purchase Agreement (Attachment 2), and

The Trust Agreement identifies the duties and responsibilities of the Trustee, establishes the terms and conditions which the bonds are to be issued, and to secure the payment of the principal and interest. The not-to-exceed amount is meant to create enough flexibility for the City to pay off (1) 100% of its UAL ($289.3 million) if it desires (or anything lower), (2) a portion of its remaining FY 2022/23 UAL amortization payment, and (3) costs of issuance.

The City is not committed to any specific amount as staff and the financing team will be evaluating a full range of options to ensure the most optimal size and structure is executed. The preliminary analysis provided in the presentation and required good faith cost estimates are based on a total bond size of $304.4 million.
SCHEDULE

With City Council approval of the resolution, the validation process will be initiated. During the validation period, staff and the financing team will refine the various options for the POBs. These options may include evaluating different sizes of POBs, amortization shapes, maturities (length of term) and targeted funded ratios.

City staff will return to Council with an update at the conclusion of a successful court validation. This exact date will be dictated by the actual duration of the validation period but is anticipated to conclude by the end of the calendar year, December 2022.

Adopting the Resolution and commencing the validation process does not in any way obligate the City to issue the POBs, it simply provides the City with a basis to issue POBs in the future. Approval to issue a POB, draft Preliminary Official Statement, and proposed financing would be required by the City Council at a future date.

RESOLUTIONS

A. Resolution No. 2022-89 authorizing judicial validation proceedings relating to the issuance of bonds to refund certain pension obligations of the City

ATTACHMENTS

a. Attachment 1 – Trust Agreement
b. Attachment 2 – Bond Purchase Agreement