City of San José

ITEM #1

City Council and Retirement Boards Joint Meeting

Implications of COVID-19 to the City's Budget

October 16, 2020

Presenters:
Jim Shannon, Budget Director
Julia H. Cooper, Director of Finance
Nikolai J. Sklaroff, Deputy Director, Debt & Treasury Management

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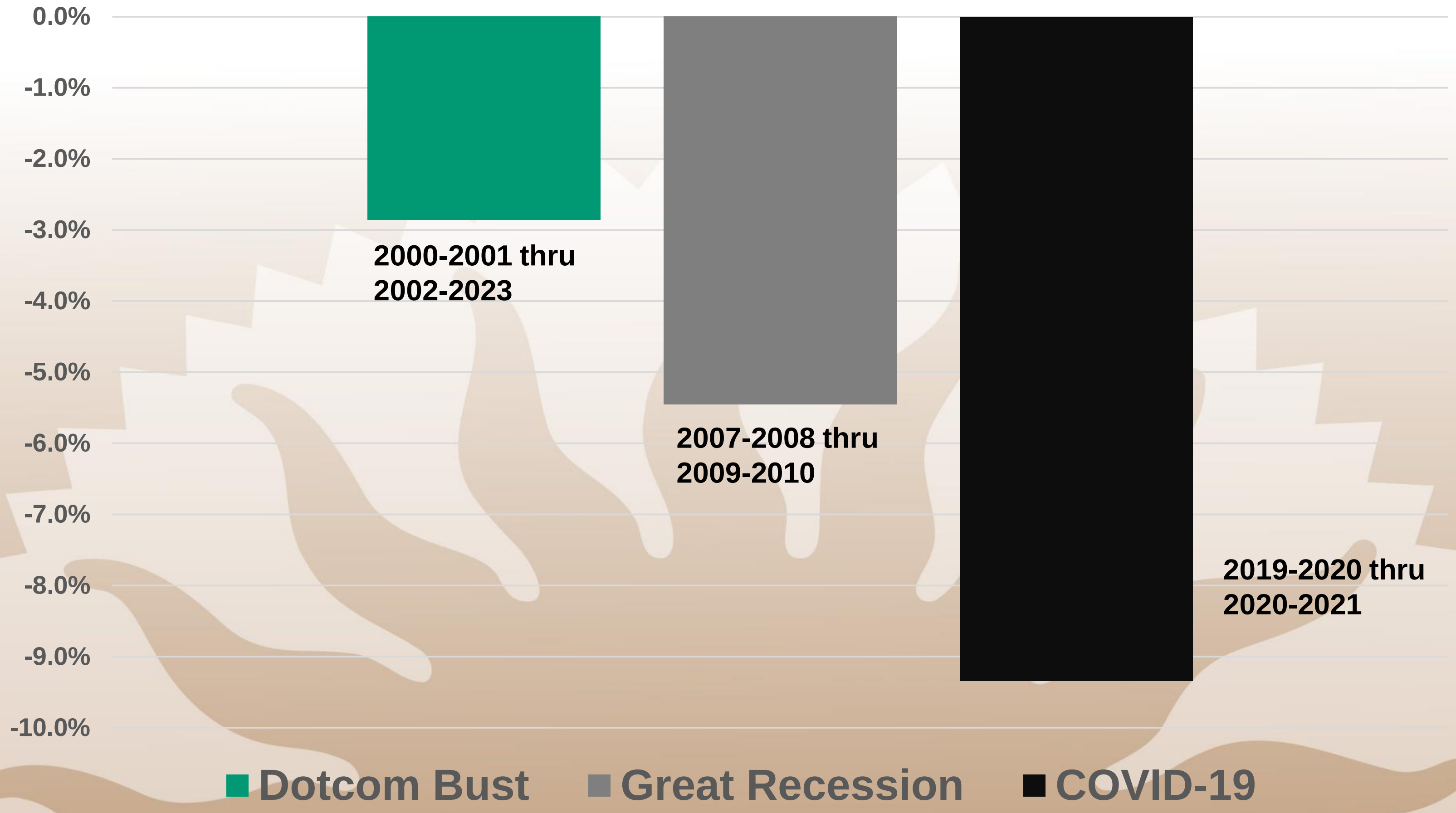
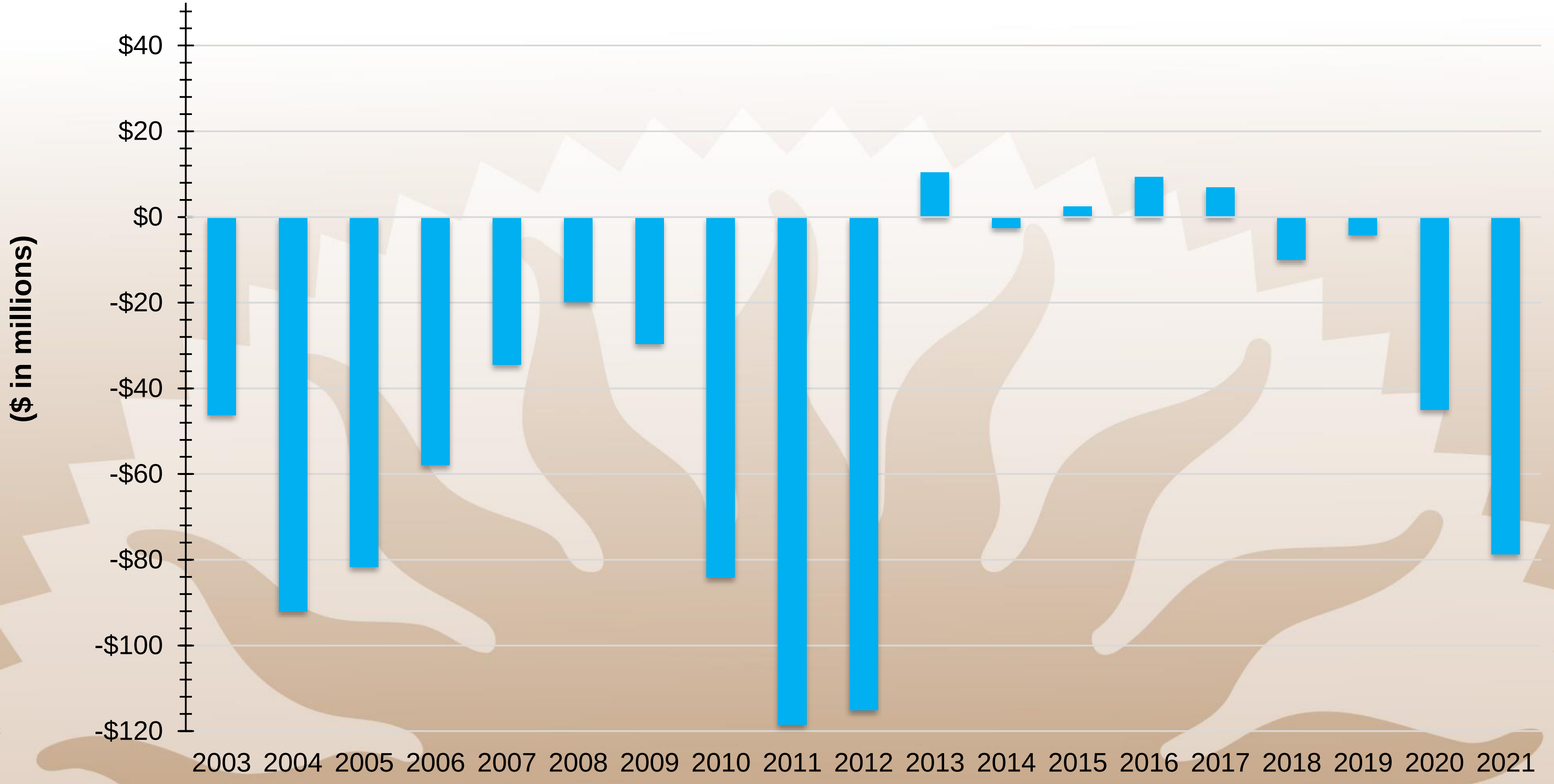
COVID-19 Impact to the City's Budget

- Immediate impacts to several major sources of revenue
- Resolved a $45.0 million shortfall for 2019-2020
- Resolved a $76.7 million shortfall and adopted a balanced budget for 2020-2021

Comparison of General Fund Revenue Loss



General Fund Shortfalls Resolved



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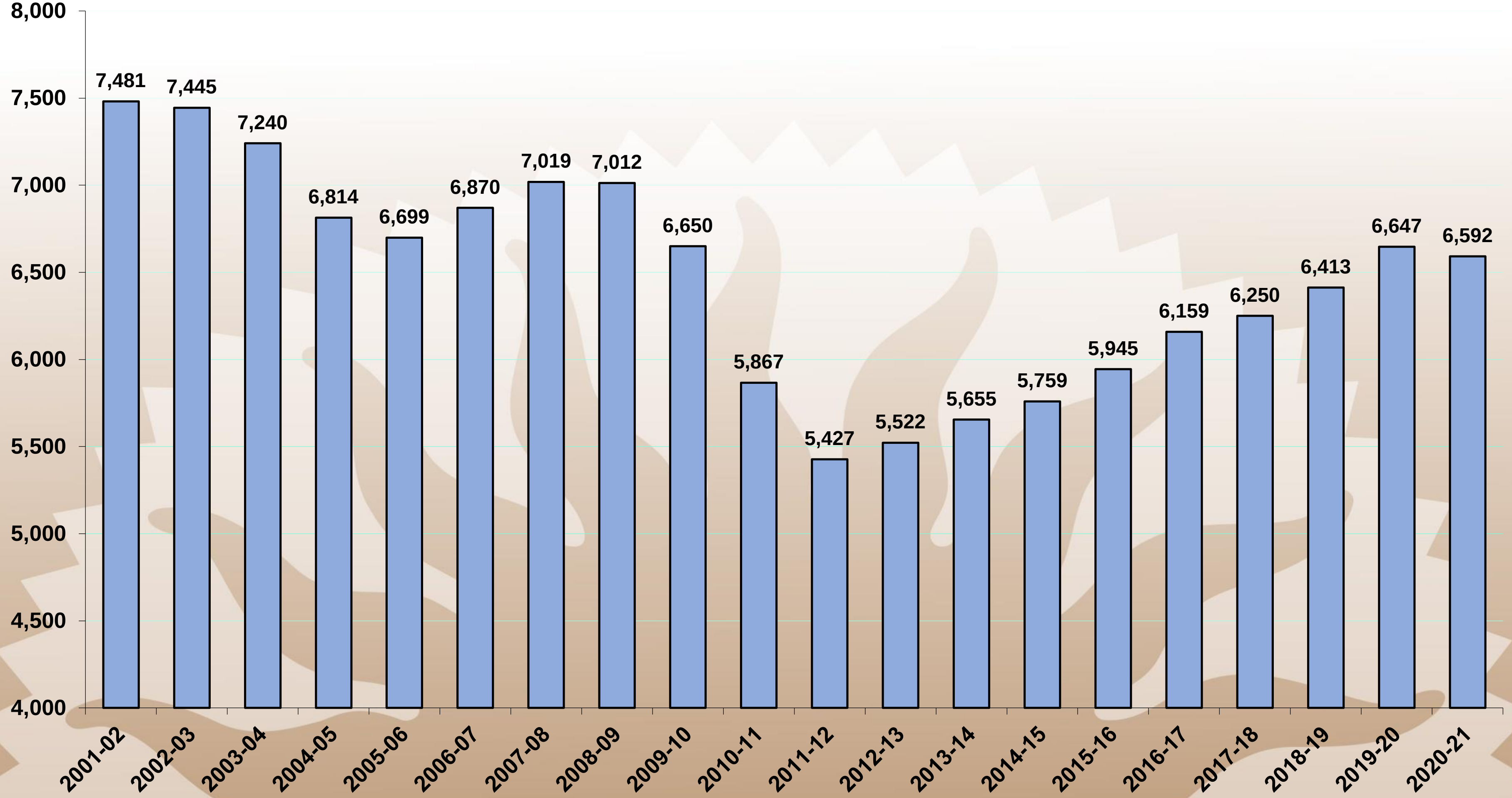
Budgeted Positions Declined in 2020-2021
(All Funds)



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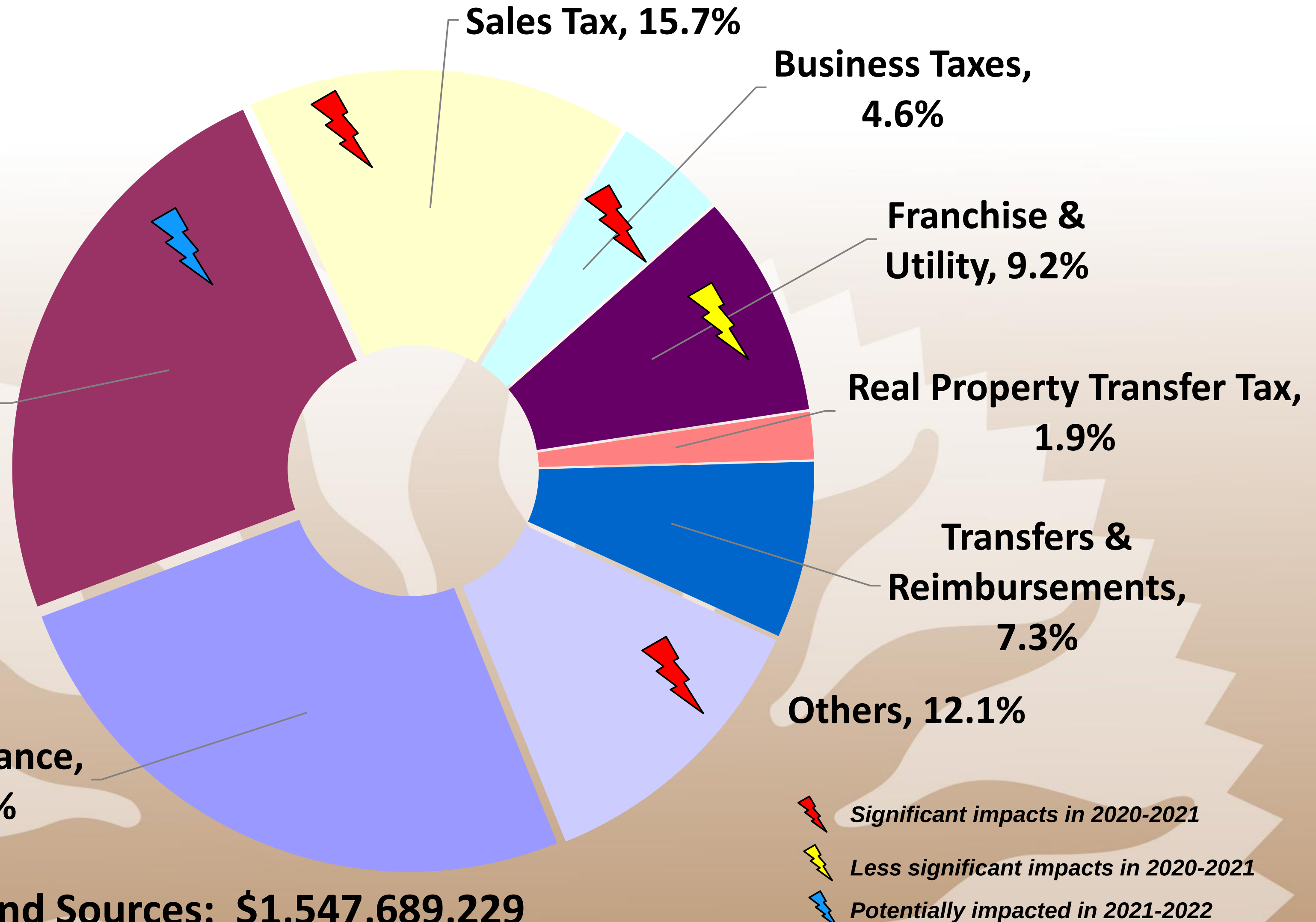
2020-2021 Adopted Budget

General Fund Sources



Total General Fund Sources: $1,547,689,229

Strategies to Resolve the $76.7 million 2020-2021 General Fund Shortfall

Approximately $40 million of solutions with no service and/community impact, including:

- Revenue Capture Agreement ($22.0 million)
- Pre-funding of City retirement contributions ($7.4 million)
- Leveraging bond refunding savings to pay down other debt ($4.2 million)
- Fuel Savings ($940,000)

Targeted reductions of approximately $11 million impacting City services

Used one-time funding/savings of $25.7 million

Budget Challenges Continue into 2021-2022 and Beyond

Direct COVID-19 impacts expected to continue at least through 2020-2021, with lingering impacts into future years

Starting 2021-2022 with an ongoing shortfall due to the use of $25.7 million in one-time funding to balance 2020-2021; this shortfall is likely to increase with the revised forecast to be released in February 2021

While the economy is shifting, long-term impacts from job losses are anticipated

Property Tax revenues likely impacted for 2021-2022

City continues to experience high retirement contributions

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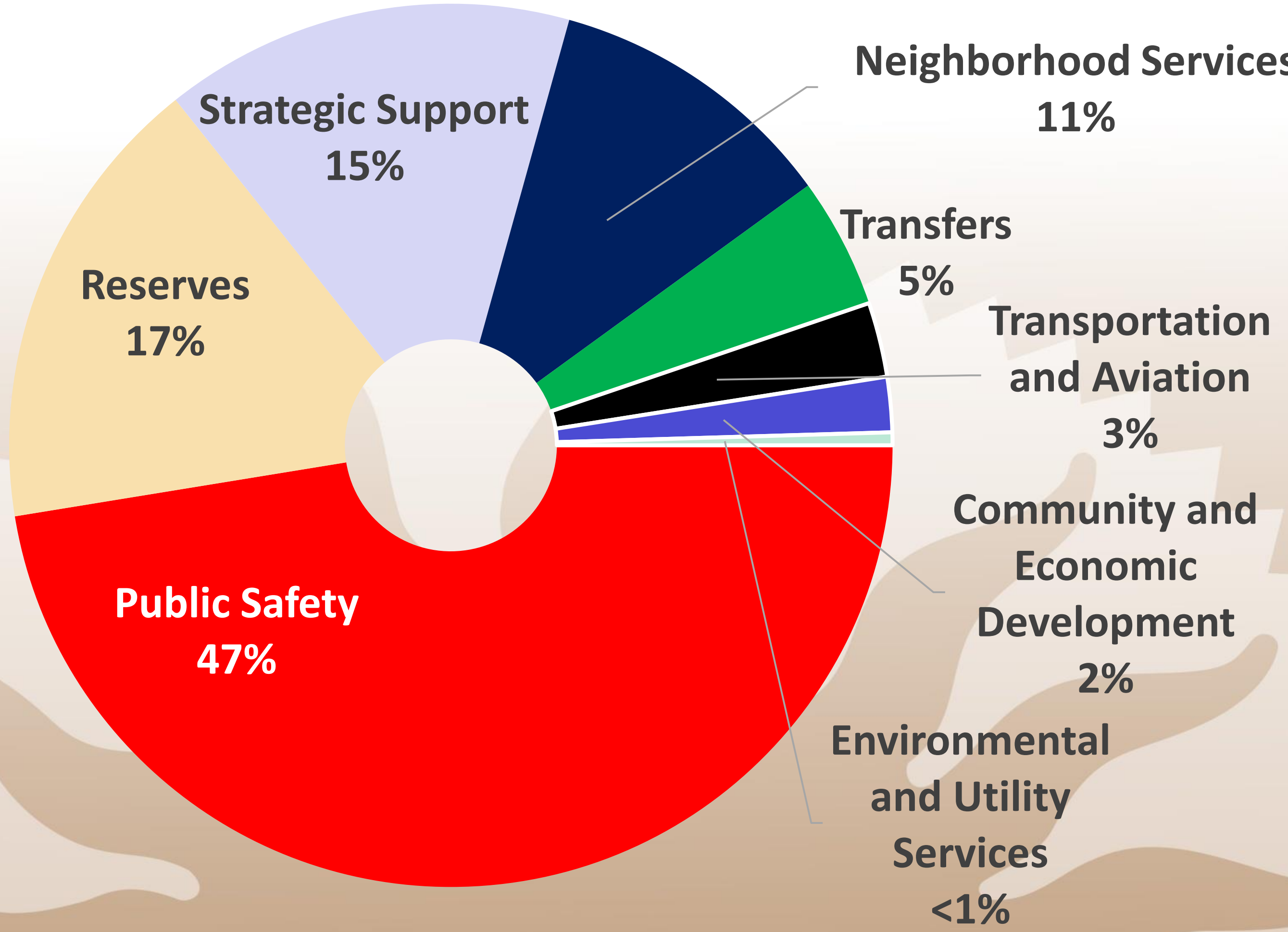
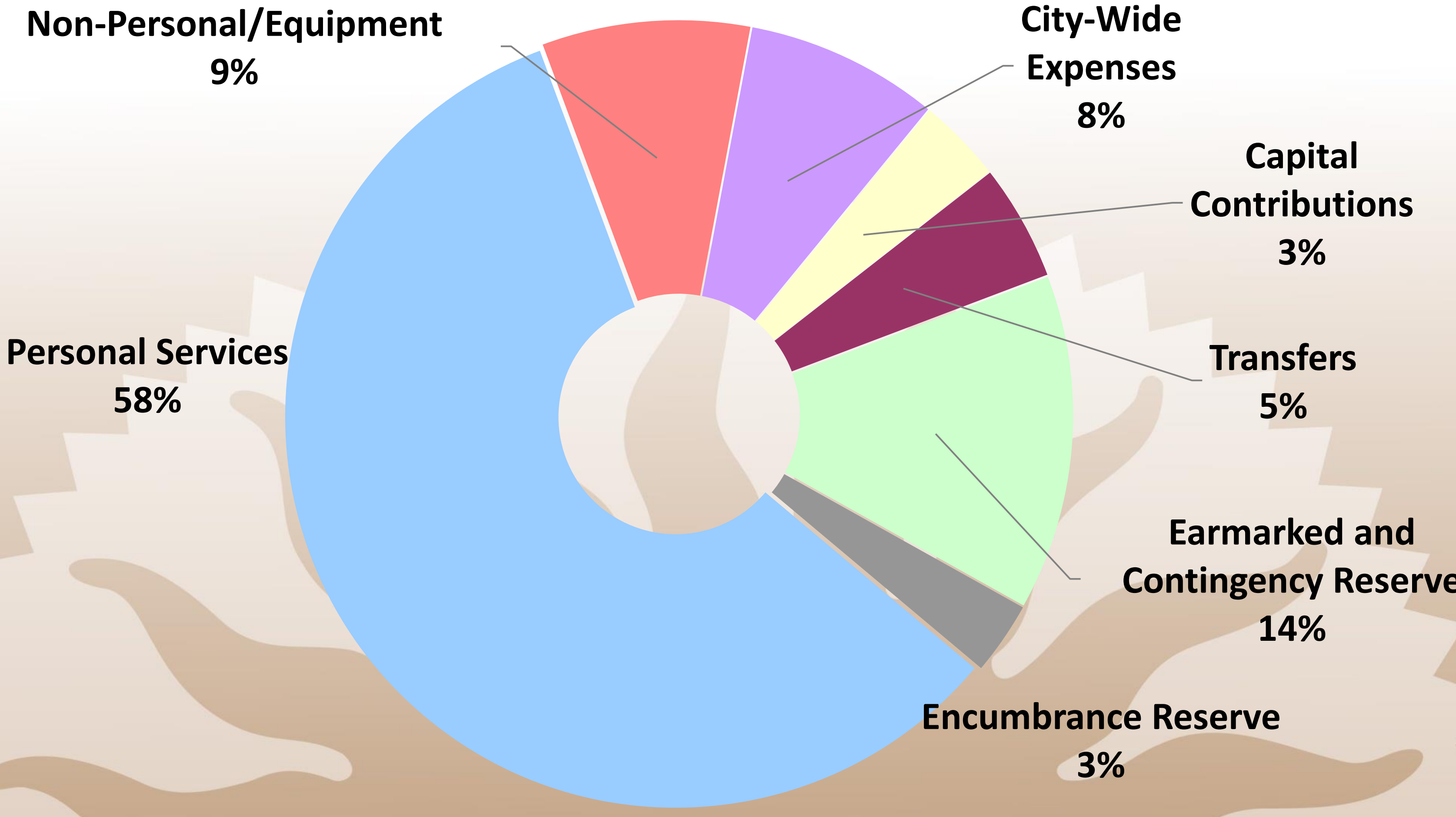
2020-2021 Adopted Budget
General Fund Uses by CSA



Total General Fund Uses: $1,547,689,299

2020-2021 Adopted Budget

General Fund Uses by Expense Type



Total General Fund Uses: $1,547,689,299

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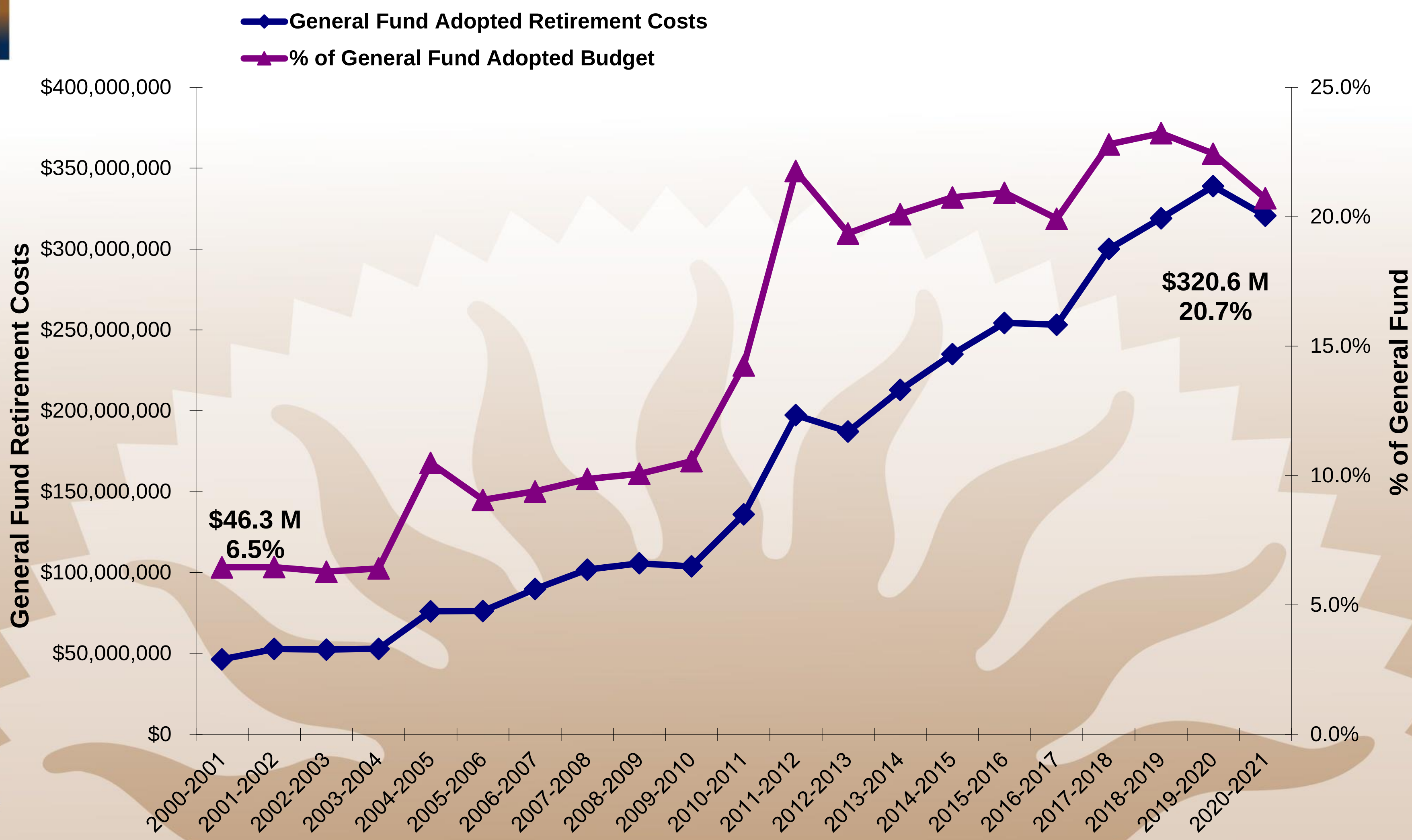
Escalating Retirement Costs in the General Fund



2020-2021 Adopted Budget
General Fund Retirement Contributions

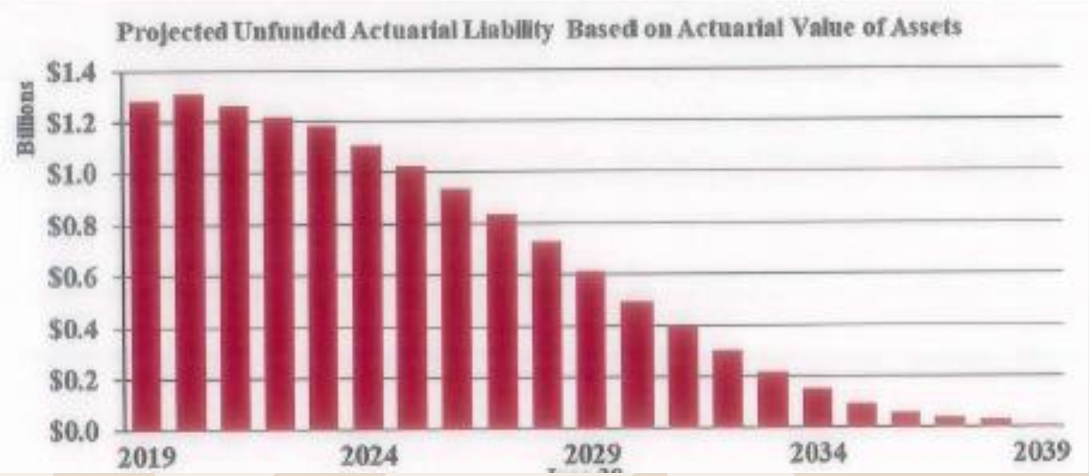
Retirement Contribution Component	Police and Fire ($ Millions)	Federated ($ Millions)	Total ($ Millions)
Tier 1 Pension (Normal Cost)	51.2	12.9	64.1
Tier 2	10.2	7.5	17.7
Unfunded Actuarial Liability	**136.7**	**67.5**	**204.2**
Retiree Healthcare	25.0	9.6	34.6
Total	**223.1**	**97.5**	**320.6**

Unfunded Actuarial Liability – 2019 Valuation Report

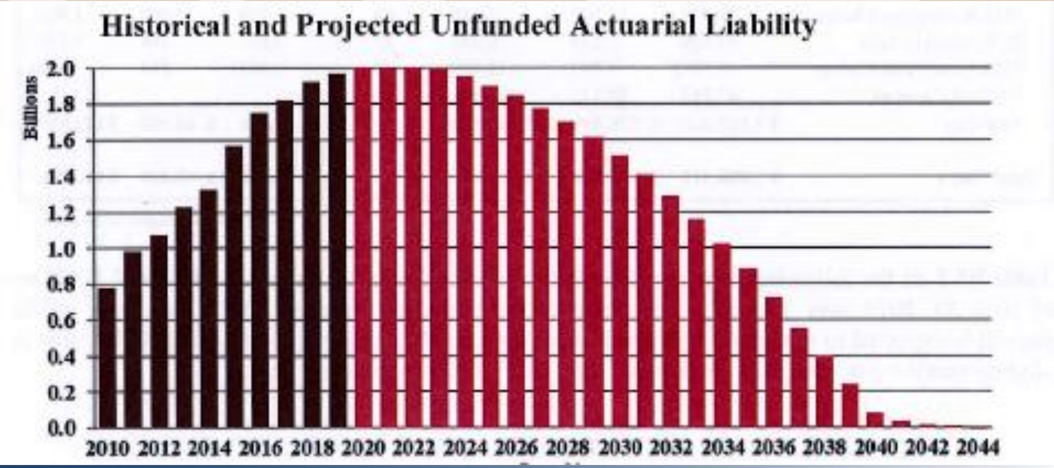
The UAL will continue to be a major cost driver for the City, especially in the General Fund for the next 15 to 20 years.

Identifying ways to lessen the UAL's impact in the near-term would help the City address lingering effects from COVID-19 and preserve/ restore services

Police and Fire



Federated



Pension Obligation Bonds - A Tool for Reducing Pension Unfunded Liabilities

Joint Meeting of the City Council,
Federated City Employees' Retirement Board and
Police & Fire Department Retirement Board
October 16, 2020

Presenters:
Julia H. Cooper, Director of Finance
Nikolai J. Sklaroff, Deputy Director, Debt & Treasury Management

Presentation Agenda

- Background
- City's Pension Plans
- Pension Obligation Bonds
- Literature Review

Note: This is an abbreviated version of a presentation made at the Retirement Stakeholder Solutions Working Group meeting on October 13, 2020. Complete City and Cheiron (the Plans' Actuary) presentations are available on the Office of Employee Relations webpage:

City Presentation: https://www.sanjoseca.gov/Home/ShowDocument?id=65229

Cheiron Presentation: https://www.sanjoseca.gov/Home/ShowDocument?id=65251

Background - Prior Review of Pension Obligation Bonds

- Commencing in October 2007, with Mayor Reed's formation of the Budget Shortfall Advisory Group (BSAG) and, in March 2008, the City Manager formed the General Fund Structural Deficit Task Force to support the work of BSAG

- In November 2008, City Manager released report, "General Fund Structural Elimination Plan"[1] which included a summary of strategies identified by the Stakeholder Group formed in March 2008 to eliminate the General Fund Structural Deficit

[1] https://www.sanJoséca.gov/Home/ShowDocument?id=50585

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Background - Prior Review of Pension Obligation Bonds

- General Fund Structural Elimination Plan made several recommendations to reduce the City's pension costs in the context of budget balancing proposals:
  - ❖ Exploration of Pension Obligation Bonds (POBs) was a strategy the entire Stakeholder Group expressed interest in being pursued
  - ❖ Annual Prepayment of City's pension obligation was also a strategy the entire Stakeholder Group expressed interest in being pursued
  - ❖ City implemented recommendation and prepaid annual pension obligations from FY 2008-09 to FY 2018-19 and commenced again in FY 2020-21

Background -
Prior Review of Pension Obligation Bonds

- In 2010, the Mayor's March Budget Message as approved by the City Council, direction given to the City Manager "*to analyze the benefits and drawbacks of issuing pension obligation bonds, and report to City Council during the budget process.*"

Background - Prior Review of Pension Obligation Bonds

- In May 2010, an Informational Memo was distributed to the City Council which concluded that:
  - ❖ POBs were not a viable tool under any scenario to address the 2010-2011 shortfall
  - ❖ General stock market conditions were not right, even if Council was willing to assume the risk of financial loss, especially given 6-12 month process for required court validation action
  - ❖ Significant caution provided on market-volatility risks of POBs, and potential financial losses to the City over the long term which existed even with optimistic assumptions
  - ❖ Further exploration needed to occur in the context of a comprehensive look at pension system cost mitigation, including who bears the cost of any potential losses

City Pension Plans - Status of Pension Plan Funding in 2009

Pension Plan	Unfunded Accrued Liability (UAL)[1]	Funded Ratio [2]	UAL as % of Covered Payroll	Assumed Earnings Rate
Federated	$729.6 million	70.7%	226%	7.75%
Police & Fire	$393.9 million	86.7%	154%	8.00%

1. UAL as of June 30, 2009 valuation date.
2. Pension system only. Funded ratio (Actuarial Value of Assets) as of June 30, 2009.

Source: Comprehensive Annual Financial Report 2018-2019 San José Federated Employees' Retirement System and Comprehensive Annual Financial Report 2018-2019 San José Police & Fire Retirement Plan

City Pension Plans - Status of Pension Plan Funding in 2019

Pension Plan	Unfunded Actuarially Liability (UAL)[1]	Funded Ratio [2]	UAL as % of Covered Payroll	Assumed Earnings Rate
Federated	$1,972 million	53%	629%	6.75%
Police & Fire	$1,282 million	74%	544%	6.75%

1. UAL as of June 30, 2019 valuation date.
2. Pension system only. Funded ratio (Actuarial Value of Assets) as of June 30, 2019.

Source: City of San José Federated Employees' Retirement System Actuarial Valuation Report as of June 30, 2019, produced by Cheiron (December 2019) and City of San José Police & Fire Department Retirement Plan Actuarial Valuation Report as of June 30, 2019, produced by Cheiron (December 2019)

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Pension Obligation Bonds (POBs)

- What are POBs?
- How can POBs Save Money?
- Who is Issuing POBs?
- What are the Benefits Associated with POBs?
- What are the Risks Associated with POBs?
- What Strategies can be used to Mitigate Risks?

What are Pension Obligation Bonds?
The Mechanics of a POB Issue

Pension Obligation Bond Mechanics

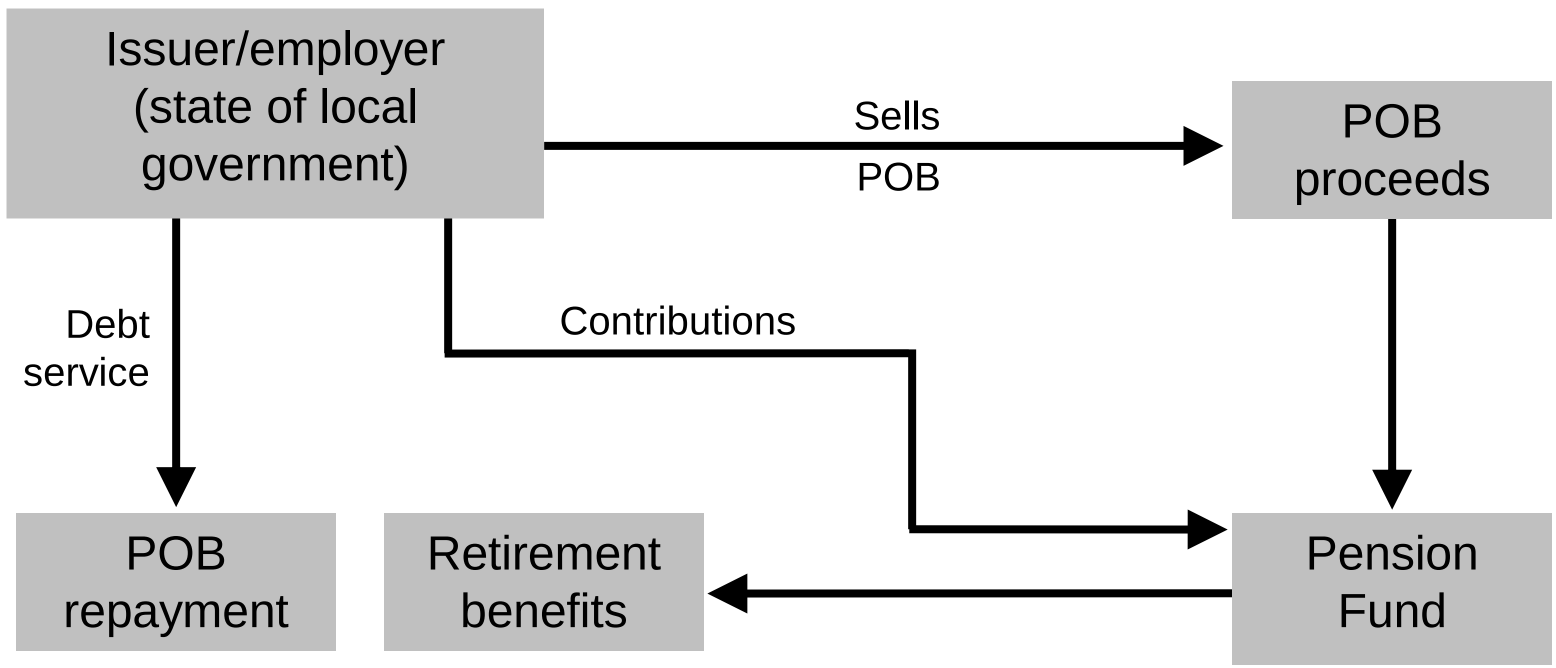


Diagram courtesy of Standard & Poor’s.

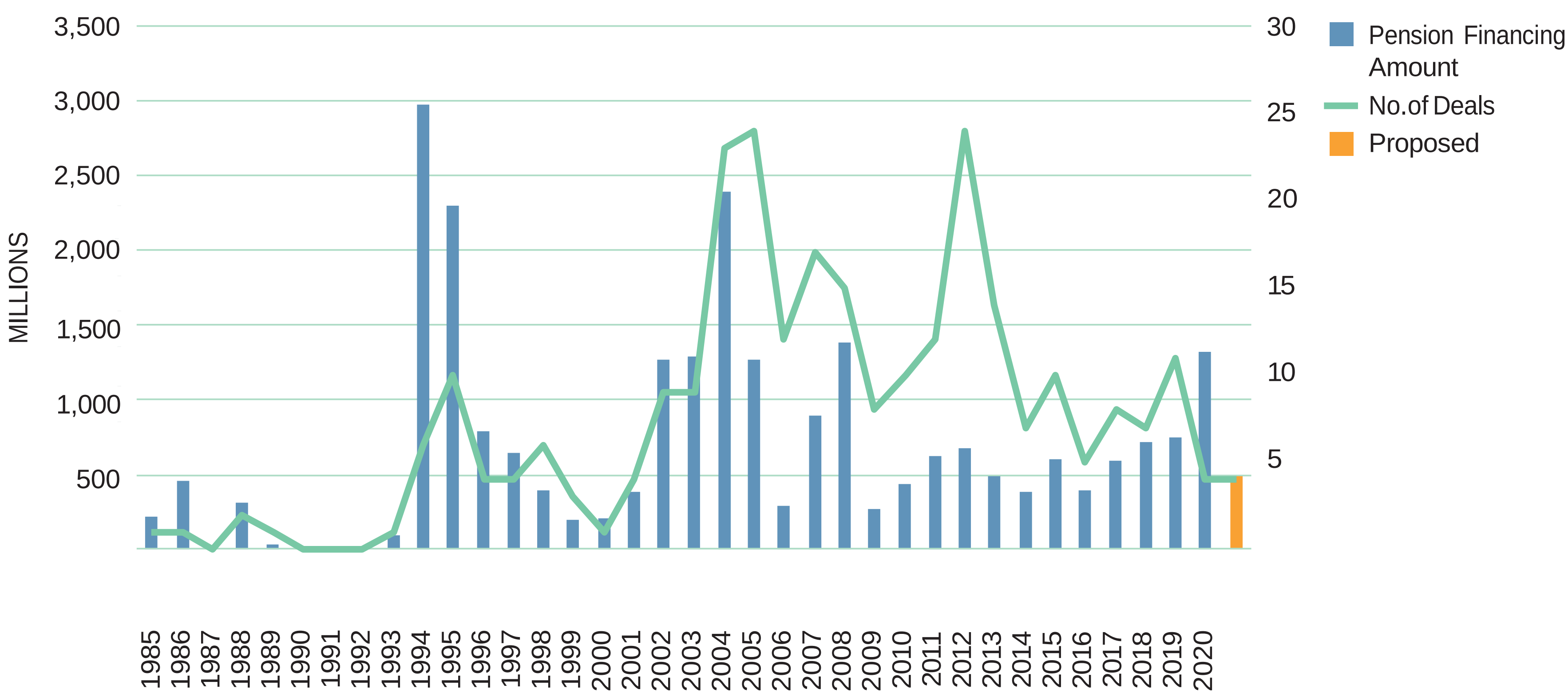
What are Pension Obligation Bonds? The Court Validation Process

- POBs fall under an exception to the constitutional debt limit because of a public agency's obligation to fund pension system payments.
- Bond counsel requires that 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.
- Validation action, at minimum, requires approximately 45-60 days from the date of filing, and an additional 30-day appeal period.

California POB and OPEB Issuance

FIGURE 1

PENSION OBLIGATION AND OTHER POST-EMPLOYMENT BENEFIT BONDS, 1985 - APRIL 2020



Source: California Debt and Investment Advisory Commission, Debt Line, Vol 39, No. 5, May 2020, page 3, https://www.treasurer.ca.gov/cdiac/debtpubs/2020/202005.pdf

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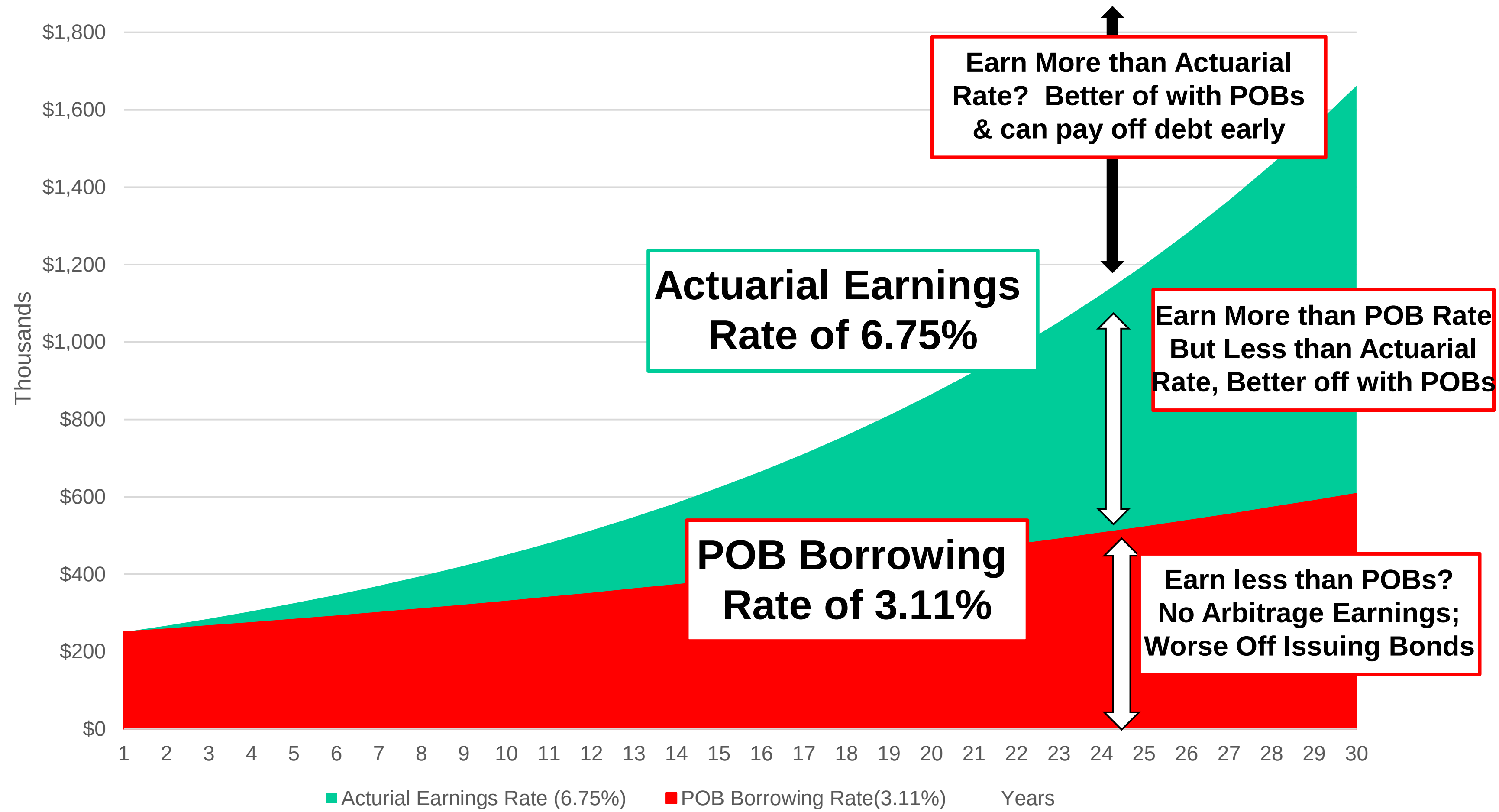
How Can POBs Save Money?

- Issued only when the borrowing costs of the bond issue is below the assumed earnings rate factored into the calculation of the UAL, producing cash flow or budgetary savings

- By issuing POBs, the City can replace the UAL (a higher cost obligation owed to the pension plans) with lower cost debt owed to bond holders, thereby producing savings.

The Economics of $250 Million of POBs



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How Can POBs Save Money?

Illustration: Potential savings assuming a $250 million POB issuance at alternative borrowing rates invested into the retirement system at alternative returns over the life of the bonds

Sample Scenarios *($ in millions)*		**POBs Borrowing Rate**		
		Current rate (3.11%)	**Current + 100 bps (4.12%)**	**Current +150 bps (4.63%)**
Average Actual Earnings Rate	**6.75%**	A: $6.6 PV: $118.4	A: $4.7 PV: $76.4	A: $3.6 PV: $57.9
	6.50%	A: $6.1 PV: $109.3	A: $4.1 PV: $68.3	A: $3.1 PV: $50.3
	6.25%	A: $5.6 PV: $100.3	A: $3.6 PV: $60.3	A: $2.6 PV: $42.7

1 A = Average Annual Savings (in millions); PV = Present Value Savings (in millions)
2 Market conditions as of February 27, 2020
3 Present value calculated at respective true interest costs
4 POB figures assume level annual dollar savings, $250 million funding of UAL, and 30-year term.

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What are the Potential Benefits Associated with POBs?

- Initial Reduction in UAL
- Savings
- Market timing
- Time Value of Money

What are the Potential Risks Associated with POBs?

- Investment risk
- Market timing
- Over-funding
- Credit Risk
- Loss of Flexibility

What Strategies can be used to Mitigate POB Risks?

- Issue less than 100% of the current estimate of the UAL.
  - Minimizes the lump sum amount invested at one time and avoids the pressures from a potentially over-funded system.
- Consider issuing multiple POBs over multiple years, assuming favorable market conditions.
  - Represents a form of “dollar cost averaging” to help mitigate market timing risks.
  - Timing issuances at key Market Cycles (during low equity market cycles and low interest rate environment)
- Mitigation of market/credit risks
  - Ensure adequate spread between borrowing rate and assumed earnings rate.
  - Avoid riskier bond structures, such as variable rate debt and interest rate swaps.
- Be Prepared to Issue POBs, when time is right
  - Prepare financing documents, establish minimum savings target and wait for favorable market conditions.

Conclusion

The full effect of issuing pension obligation bonds can only fully be tallied at final maturity of the bonds when actual investment performance of the retirement plan can be measured.

Literature Review

Government Finance Officers Association Pension Obligation Bond Advisory[1]

Recommends state and local governments do not issue POBs for following reasons:

- Invested POB proceeds may fail to earn more than interest rate owed over bond term thereby increasing overall liabilities
- Complex POB instruments carry considerable risk especially if derivative products are utilized
- Issuing taxable debt increases jurisdiction's bonded debt burden potentially using debt capacity that could be used for other purposes
- If POBs are structured with deferred principal amortization or repayment longer than actuarial amortization period overall borrowing costs will increase
- Rating agencies may not view as credit positive, especially if not part of more comprehensive plan to address pension funding shortfalls

[1]GFOA's Advisories identify specific policies and procedures necessary to minimize governments exposure to potential loss in connection with financial management activities (https://www.gfoa.org/print/3546

S&P Credit Considerations[1]

- Review of overall financing plan, including timing
- Some of the issues and circumstances S&P considers in the rating process include:
  - How will the financing affect current contributions?
  - Are the POBs being issued for budget relief?
  - Will any front-loading of savings lead to higher, unsustainable contribution rates in later years?
  - How have the laws and precedents for contributing affected funding progress, and how do they play into the POB strategy?
  - What are the funding goals and how will the POB affect these objectives

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[1]*Pension Obligation Bonds' Credit Impact On U.S. Local Government Issuers,* S&P Global Ratings, December 6, 2017

"Pension Obligation Bonds May Soon Have Their Moment"[1]

- Scenario in which POB may make financial sense …
  - U.S. economy enters a recession and equities, cornerstone of public pension plans, will likely have slumped
  - Benchmark U.S. Treasury yields, already at near all-time lows, could head even closer to zero as investors seek safety

- Yes, it is market timing, and *"with prudent management – and under the right conditions – it's not so much a gamble as an automatic stabilizer*."
  - Difference today is *"stark drop in nominal bond yields vs. the end of the last recession*"

- *"Lower-for-longer interest rates present a unique opportunity for government officials to dig out faster than before. Make no mistake – POBs are not a cure-all. But layered on top of required payments, they just might help defuse the ticking pension time bomb that seems destined to explode."*

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https://www.bloomberg.com/news/articles/2019-10-10/pension-obligation-bonds-may-soon-have-their-moment

Additional Research Materials

- Center for State & Local Government Excellence
  - Pension Obligation Bonds: Financial Crisis Exposes Risks, January 2010 (https://slge.org/resources/pension-obligation-bonds-financial-crisis-exposes-risks)
  - An Update on Pension Obligation Bonds, July 2014 (https://slge.org/resources/an-update-on-pension-obligation-bonds)

- Orrick
  - An Introduction to Pension Obligation Bonds and Other Post-Employment Benefits, Third Edition, September 26, 2006 (https://www.orrick.com/api/content/downloadattachment?id=720651b1-dbcf-456b-b71b-c199fd854d79)
  - Webinar: Recent Developments in Pension Obligation Bonds, August 2017 (https://www.orrick.com/en/Insights/2017/08/Webinar-Recent-Developments-in-Pension-Obligation-Bonds)

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Additional Research Materials

- Center for Retirement Research at Boston College
  - An Update on Pension Obligation Bonds, July 2014 (https://crr.bc.edu/wp-content/uploads/2014/07/slp_40.pdf)
  - Pension Obligation Bonds: Financial Crisis Exposes Risk, January 2010 (https://crr.bc.edu/wp-content/uploads/2010/01/SLP_9-508.pdf)

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Information Memo

"Pension Obligation Bonds"
May 14, 2010

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