CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Presentation to the
Police and Fire Department Retirement System

Discussion of City Staff's Objectives and Approach to Potential Issuance of Pension Obligation Bonds

September 9, 2021

Introductions

City Administration

- **Julia H. Cooper,** *Director of Finance*
- **Jim Shannon,** *Budget Director, City Manager's Office*
- **Nikolai J. Sklaroff,** *Deputy Director of Finance, Debt & Treasury Management Division*
- **Cheryl Parkman,** *Assistant to the City Manager, Office of Employee Relations*

Municipal Advisor to the City

- **Michael Busch,** *Urban Futures, Inc.*
- **Julio Morales,** *Urban Futures, Inc.*
- **Wing-See Fox,** *Urban Futures, Inc.*

Agenda

Opening Comments

Part I — The Challenge: Unfunded Accrued Liabilities ("UAL") Funding

Part II — City Goals, Policy Considerations, and Approach to Pension Obligation Bonds ("POBs")

Part III — POBs 2.0

Part IV — Evaluating Outcome of POBs

Part V — Final Considerations and Q&A

Opening Comments

March 2019 – The Mayor's March Budget Message called for a Stakeholder group to convene to discuss the impact of retirement contributions on the General Fund

November 2019 – Meetings commenced with the Retirement Stakeholder Solutions Working Group (RSSWG) and issued final report April 2021

April 2021 – POB Study Session with City Council

Evaluate all available options with extensive risk/scenario analysis:

- Improve funding levels of the City's two retirement plans
- Meaningful reduction in the City's UAL payments

POBs are the "last tool in the toolbox"

Putting the Tool in the Toolbox—Judicial Validation

1. Filing the Validation Complaint
2. Seeking permission from the Santa Clara Superior Court ("Court") to publish the summons so the Court can gain subject matter jurisdiction over the validation
3. Publish the summons (once a week for three consecutive weeks, totaling 21 days)
4. Response period to file an answer (10 days following completion of publication)
5. Clerk of the Court's Entry of Default Judgment if no answer to Complaint is filed
6. File "points and authorities" Memorandum seeking entry of Default Judgment
7. Hearing on Judgment and Judge's execution of Judgment
8. Begin 30-day appeal period
9. After 30-day appeal period, Council may then adopt a Resolution approving Preliminary Official Statement and confirm size and structure of POBs
10. Issue POBs

Part I

The Challenge: Unfunded Accrued Liabilities (“UAL”) Funding

Julia H. Cooper, *Director of Finance*
Cheryl Parkman, *Assistant to the City Manager*

The Challenge – UAL Funding Status

Unfunded Accrued Liability (UAL)
as of June 30, 2020

Accrued Liability	$5.235 Billion
Actuarial Value of Assets	3.852 Billion
Unfunded Accrued Liability	**$1.383 Billion = 74% Funded**

S&P Financial Health Threshold = 80%

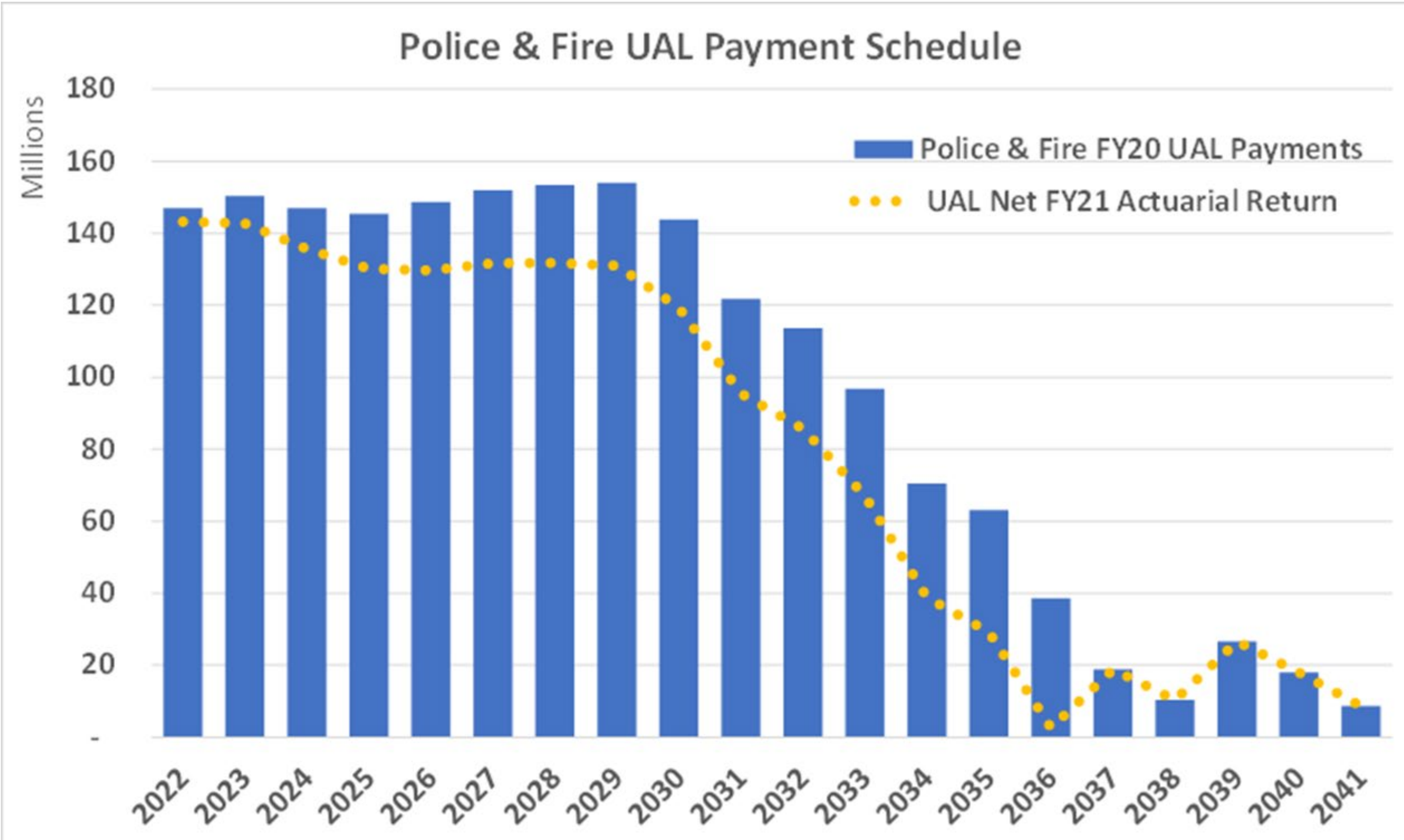
Comparison to Other Agencies & Benchmarks

- NCPERS – 75% (2020 National Survey)
- CalPERS – 71% (June 30, 2020)
- LACERS – 66% (June 30, 2020)
- SFERS – 91% (June 30, 2020)

FY21 Return of 25.25% = 77% Funded on an actuarial basis

Police & Fire Plan UAL Payments

FY21 return improves funding level, but still not at target funded status



- $914 million (5-year phase-in)
- 2.5% escalation factor

City is rated Aa1/AA+/AA+ but Pension Liability is a Concern

AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-

- Positive Credit Considerations
  - Strong Reserves and Liquidity
  - Economic Strength, Large and Diverse Tax Base
  - Strong Executive Management
  - History of Fiscal Responsibility / Prudent Financial Policies

- Credit Concerns
  - **Pension/OPEB* liability (Credit Challenges: "High fixed costs and leverage")**
    - Very large pension/OPEB* obligations pose significant near-term budgetary pressure
    - Accelerating costs over medium term
    - Adjusted Net Pension Liability and fixed costs are elevated compared to peers
    - Plans under 80% funded warrant greater scrutiny

**Other Post Employment Benefits*

Part II

City Goals, Policy Considerations, and Approach to Pension Obligation Bonds ("POBs")

Julia H. Cooper, *Director of Finance*
Nikolai J. Sklaroff, *Deputy Finance Director, Debt and Treasury Management*

City Goals

- Ensure the long-term sustainability of the City's retirement systems
  - While the City does not control the retirement system investments, it is legally obligated to pay liabilities on both systems and therefore has an interest in maintaining the sustainability of each retirement plan
  - Improve funding ratio of plans and design plans for sustainable funding ratios
- Reduce current annual burden of UAL on all City Funds, particularly the General Fund, for Pension & OPEB, easing budget pressures
- Prevent the contributions from rising as projected through 2029
- Use savings to accelerate the amortization of unfunded liability (recycle savings)

Pension Obligation Funding Policy

City Council will adopt new and modify existing policies:

- Full description of plans & liabilities
- Financial metrics/target funding level
- Use of budget surplus and one-time monies
- How to address new bases
  - Use of reserves / 115 trust
  - Accelerated repayment schedule

- Potential Funding Sources
  - Tax-exempt exchange
  - Leveraged refunding
  - POBs
  - Recycled savings
- Base Selection Strategies
  - Additional Discretionary Payments: Long vs. Short
- POB Structuring Guidelines
  - Minimum savings threshold
  - Discount rate / POB spread
  - No extension of term
  - No financing of normal costs

Rating agencies consider whether pension funding policies, including a plan to address new bases, have been adopted

Approach to POBs

- City began considering solutions to address unfunded pension liabilities in 2007
- Evaluation of all available options to create a meaningful reduction in the City's UAL and improve the funding levels of the City's two retirement plans, especially the Federated Plan
- POBs are the "last tool in the toolbox"
  - Part of a long-term strategy and comprehensive approach for addressing UAL and pension sustainability
  - Would not be by the City to extend/re-amortize Normal Annual Costs or wholly to balance current operating budget
  - Primarily driven by desire to improve funding status of funds

Potential Benefits of POBs

- Provide large infusion of cash to make new investments either all at once or over time by issuing multiple series of bonds
- Increase the funding ratio of the Federated and Police & Fire Plans
- Reduce reliance on City Contributions

Potential Risks Associated with POBs

While City issues the POBs, both the City and the Retirement Plans share an interest in these risks:

- **Investment risk** is the principal risk
  - If the retirement plans earn less over the life of the bonds than the interest paid on the POBs, then the POB program becomes a net cost to the City
  - If plans earn less than the Discount Rate, the UAL continues to grow
- **Market timing** greatly impacts the long-term economics
  - POBs also result in **lump sum investment** by pension system of amounts that otherwise would have been paid to and invested by the pension system over time.
  - **Investment losses** early in the life of a POB program would contribute to a new unfunded liability and could require many years of future gains in order to reach "break-even"

Part III

POBs 2.0

Urban Futures, Inc. (UFI)

Michael Busch, *Municipal Advisor*

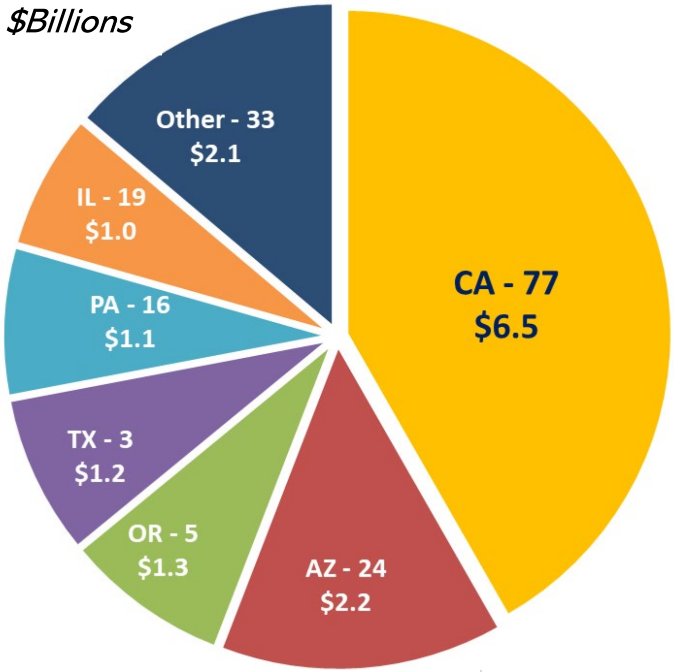
Wing-See Fox, *Municipal Advisor*

Julio Morales, *Municipal Advisor*

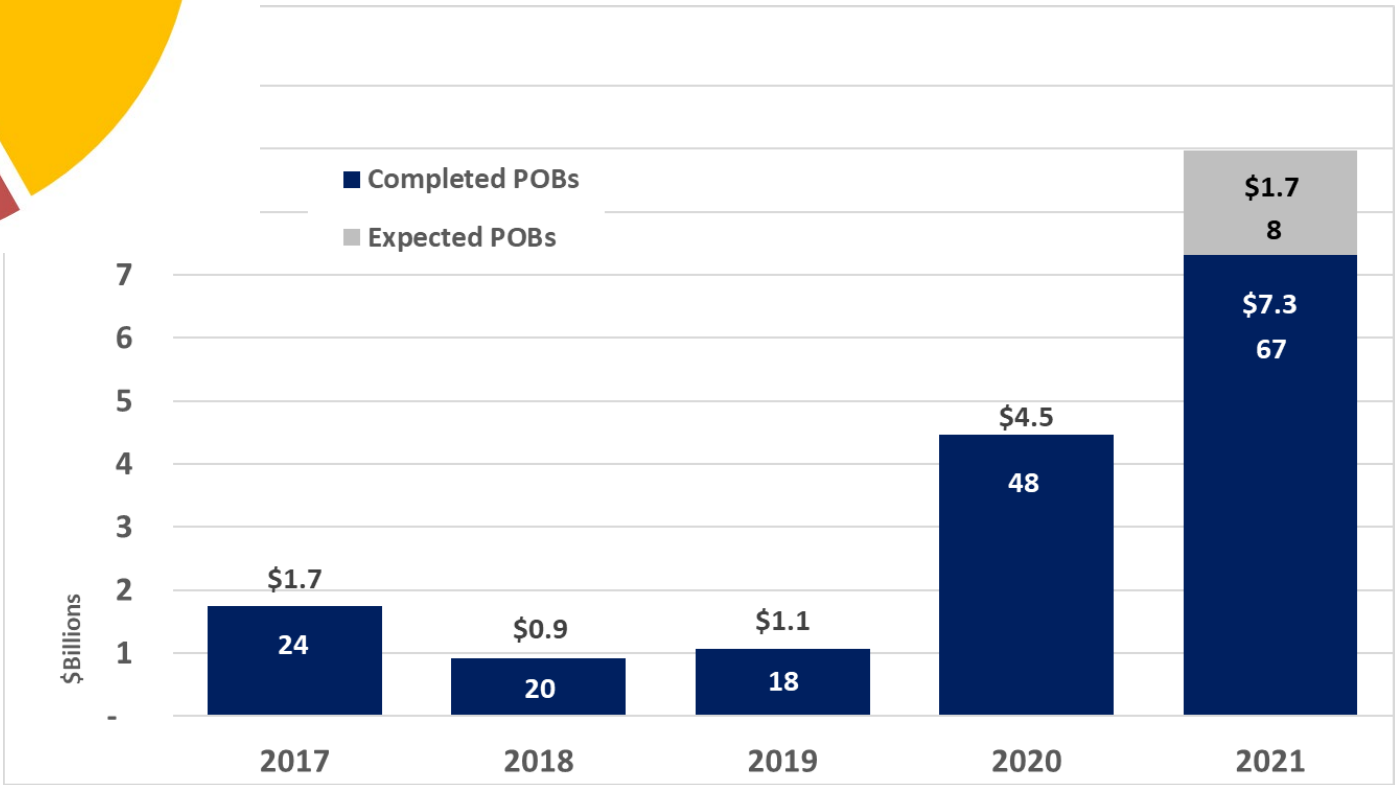
The Economics of POBs

- The Unfunded Accrued Liability for the Police & Fire Plan is determined based on the discount rate
- Discount Rate:
  - Expected rate of return of 6.625%
  - Also used to value the cost of future pension obligations in today's dollars and to amortize UAL payments
- Police & Fire Plan UAL comprised of 62 amortization bases, with individual payment schedules calculated using 6.625% discount rate (effectively loan payments at 6.625%)
- Bond market offers the ability to serialize bonds and pay rates based on the term of each maturity of bonds
- Recent long-term bonds issued for POBs have interest rates ranging from 2.58% to 3.50%

5-Year POB Issuance Trend



TOTAL
177 POBs Issued
$15.5 Billion



POBs 2.0

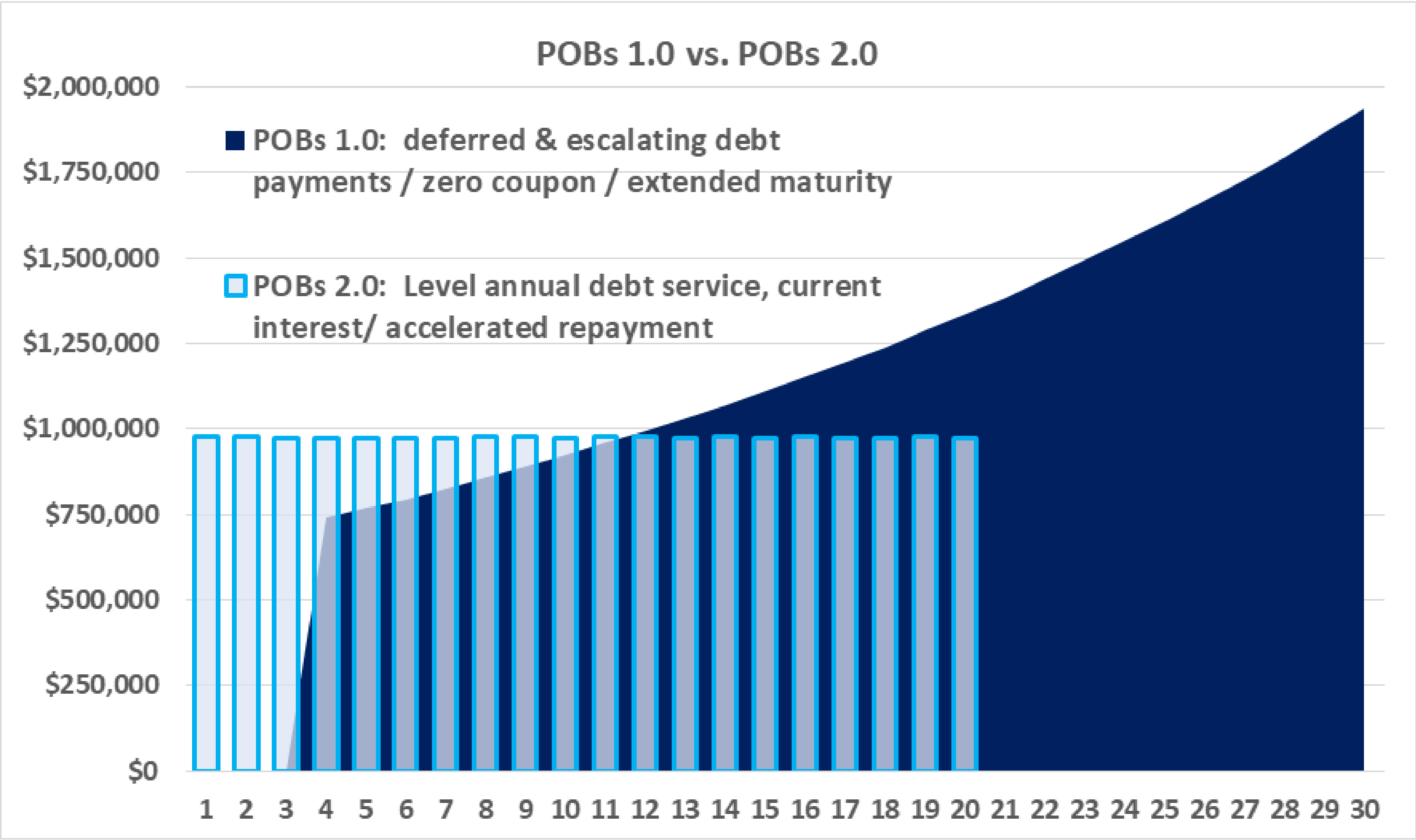
Since 2017, there has been an evolution in the market which has resulted in POBs 2.0

- GASB 68
  - New accounting guidelines require pension liabilities to be stated on the balance sheet
  - Became effective for fiscal years beginning after June 15, 2014
- In-Depth Analysis and Comprehensive Plan
  - Higher level of attention and analysis on pension liabilities
  - Evaluate multiple strategies
  - Perform scenario and risk analysis (Monte Carlo Simulation)
  - Conduct City Council and stakeholder workshops to develop and adopt a Pension Obligation Funding Policy
- Addresses pitfalls of prior generation POBs

POBs 1.0 vs. POBs 2.0

POBs 1.0		POBs 2.0
1. Complex Instruments: Swaps, Capital Appreciation Bonds, Derivatives		1. Plain Vanilla Fixed Rate Bonds
2. Increase Debt Burden / Reduce Flexibility: "Soft to Hard Liability"	POBs 2.0	2. GASB 68 Liability - Balance Sheet
3. Not Refundable "Make-Whole" Call	→	3. 10-year Par Call
4. Extend Repayment or Finance Normal Costs		4. Finance UAL Only (Same Term)
5. Stand Alone POBs Not Viewed as Credit Positive	• In-depth Study • Pension Reform • Market Evolved	5. Credit Neutral / Plan & Study +
6. Reinvestment of POB Proceeds: Market & Timing Risk		6. Dollar Cost Averaging / Multiple Strategies / Hedge

POBs 1.0 vs. POBs 2.0



Part IV

Evaluating Outcome of POBs

Urban Futures, Inc. (UFI)
Michael Busch, *Municipal Advisor*
Wing-See Fox, *Municipal Advisor*
Julio Morales, *Municipal Advisor*

Evaluating Outcome of POBs

1. UAL Savings

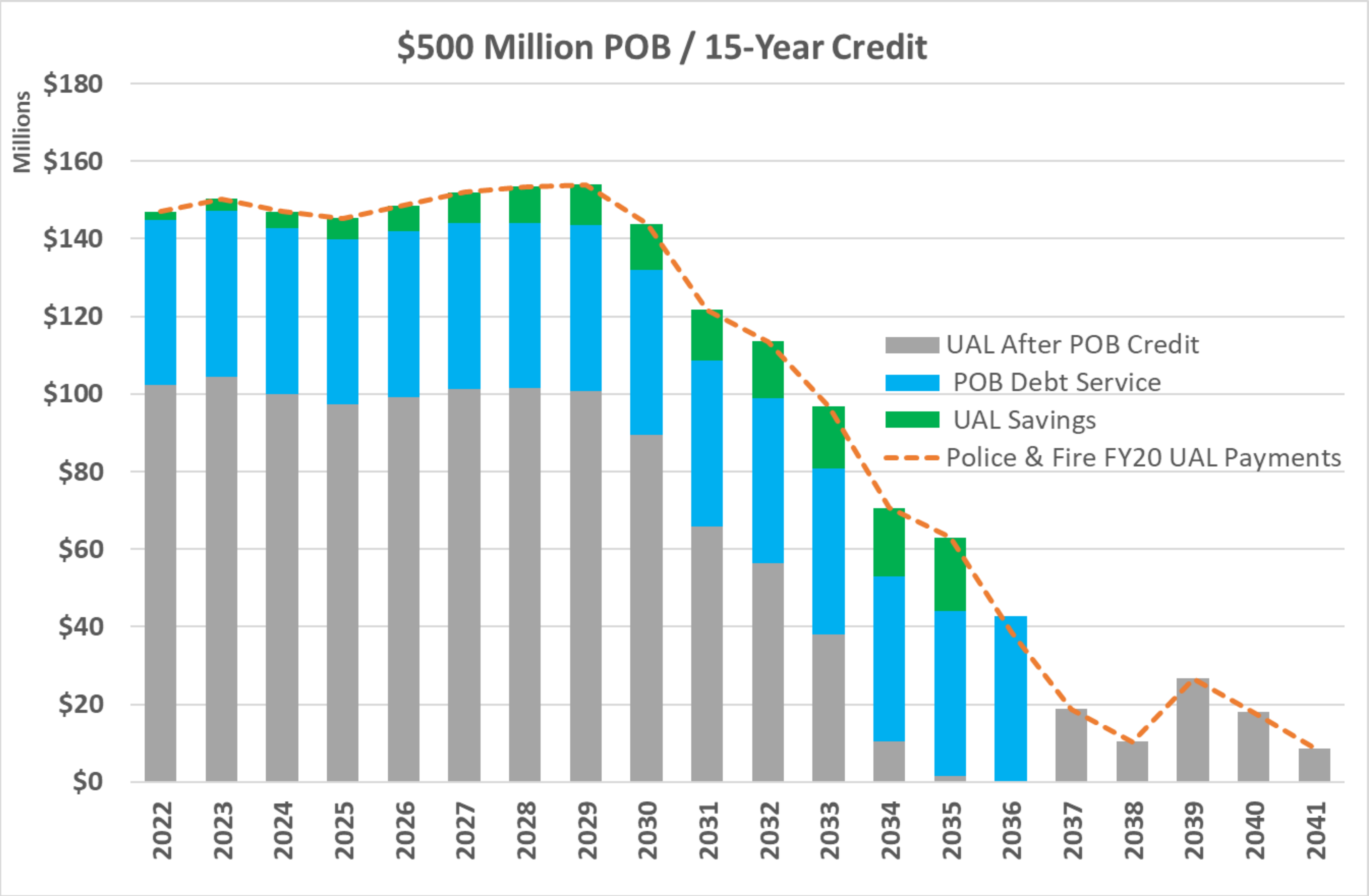
- Standard Refinancing: 6.625% vs 3.50%
- Fixed Dollar UAL Payments
- Existing Liability on Balance Sheet
- Actual Budgetary Savings
- Bond Proceeds go to Police & Fire Plan at time of Issuance

2. Plan % Return

- Market Timing Risk
- Impact of Returns is Magnified:
  - Increased benefit + return
  - Increased liability – return
- Returns During Initial Years Most Critical
- Market Timing Risk Applies to All Investments

1. UAL Savings

- POB proceeds amortized as a credit in accordance with current policy



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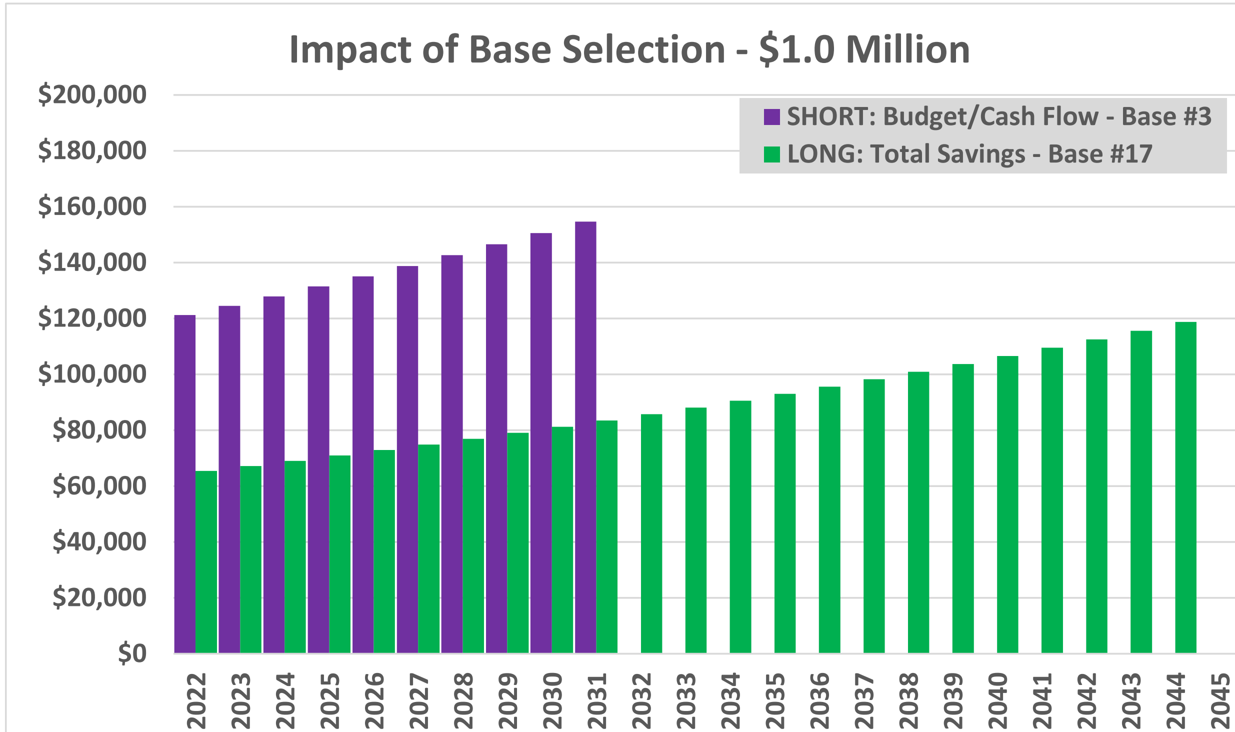
1. UAL Savings

- Base Selection
  - Selecting bases to pay off with POB proceeds achieves targeted results—widely used methodology (CalPERS)

Shorter Base = Greater Budget / Cash Flow Impact

Longer Base = Greater Total Savings



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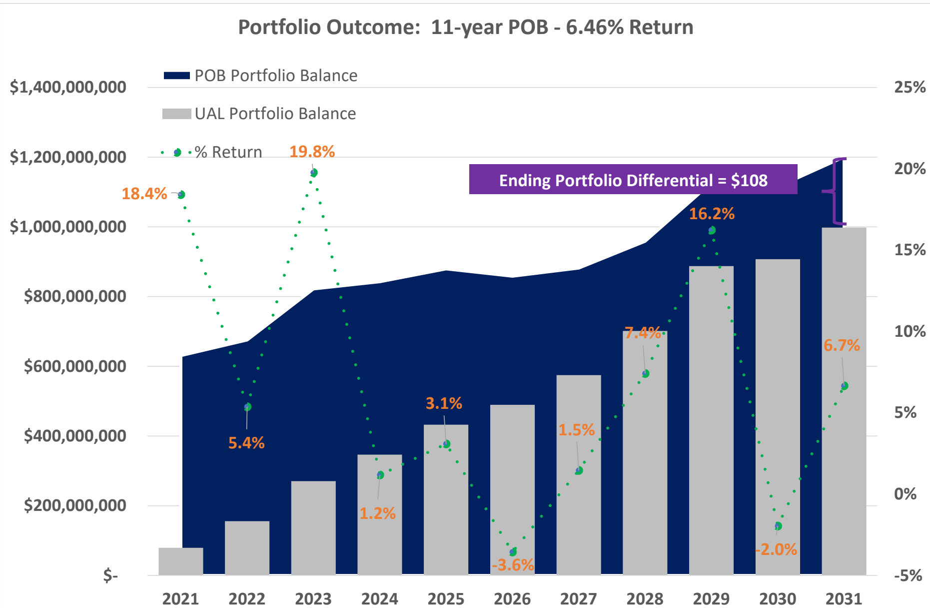
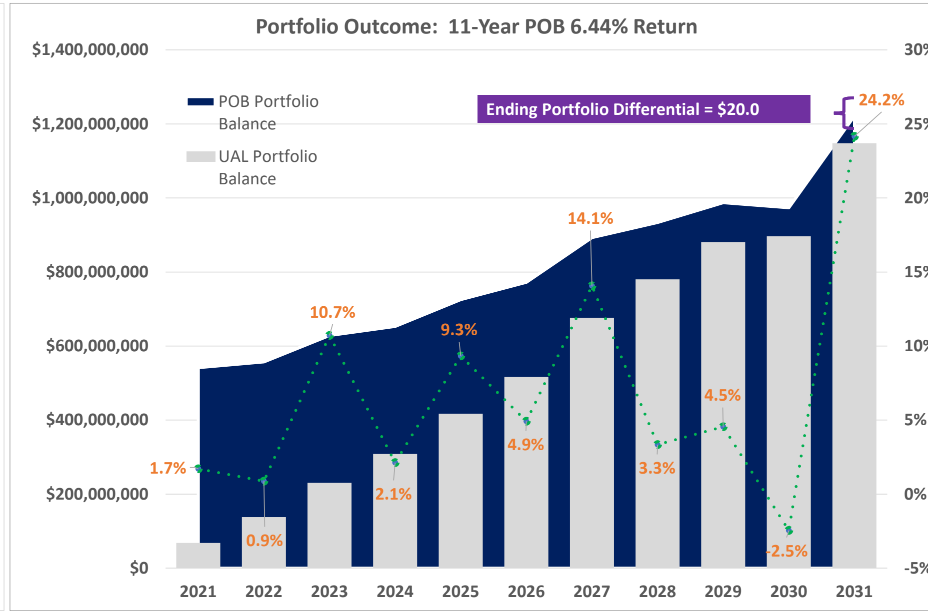
	Plan	#	Year	Term	Outstanding UAL Balance	Total UAL Payments	Avg. Annual Payment	Interest Costs	Ratio
SHORT	FED	3	2010	10	$ 40,945,000	58,114,418	5,811,442	$ 17,169,418	142%
LONG	FED	21	2018	23	$ 53,227,000	113,343,905	4,927,996	$ 60,116,905	213%

2. Plan % Return

Market Timing is Critical





Compare ending portfolio balance with two similar returns:

- 6.46% Loss Initial Years = $20 Million
- 6.44% Gain Initial Years = $108 Million

2. Plan % Return

Market Timing Risk inherent to all investments made into retirement plans, regardless of funding source

1. Dollar Cost Averaging
   - Multiple tranches of POBs can be offset by increasing borrowing rates
   - Multiple strategies
2. Hedge
   - Put or Floor S&P 500 – "at-the-money" 1-year contract = 6.0% (Bloomberg) – 100% increase from 6 months prior
   - Structured note with imbedded downside protection
   - High Dividend Yield, Low Volatility Index (Warren Buffet Strategy)

Part V

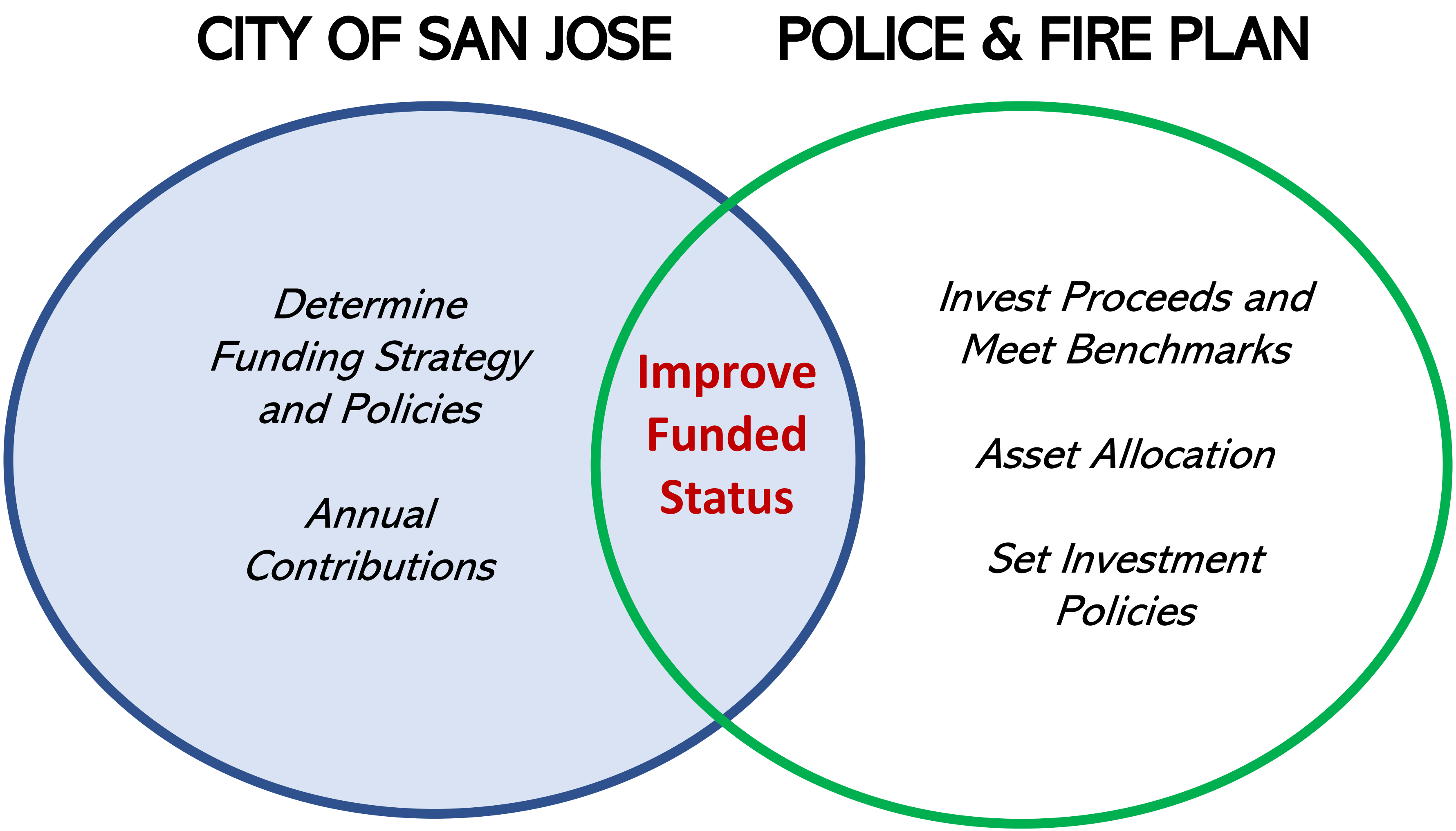
Final Considerations and Q&A

Julia H. Cooper, *Director of Finance*

Our Interests and Goals are Aligned

- Potential Positive Impacts for City
  - Reduce UAL and improve funding of plans
  - Prevent the contributions from rising through 2029 as currently projected and eroding capacity for other City programs and services
  - Use a portion of savings to
    - Accelerate the amortization of unfunded liability
    - Ease current budget pressures
- Potential Positive Impacts for Retirement Plans
  - Provide large infusion of cash to make new investments either all at once or over time by issuing multiple series of bonds
  - Increase the funding level of the Federated and Police & Fire plans
  - Reduce reliance on City contributions

Alignment of Roles



Next Steps

8/19	Federated Board Presentation (already occurred)
9/9	Police & Fire Board Presentation
9/21	Council Meeting (Approval of Judicial Validation)
9/30	Joint Council/Retirement Boards Study Session
TBD	Council Meeting (POB Policy Adoption and Continued Analysis of POB Scenarios)

Q&A

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