RULES AGENDA: 10/21/20
ITEM: G.5

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO:	RULES AND OPEN GOVERNMENT COMMITTEE	**FROM:**	Mayor Sam Liccardo
SUBJECT:	**PENSION OBLIGATION BONDS**	**DATE:**	October 15, 2020

APPROVED:		**DATE:**	October 15, 2020

RECOMMENDATION

1. Initiate the process for possible issuance of pension bond obligation to fund unfunded actuarial liability of the Federated and Police and Fire Retirement Plans, including:
    a. Develop a workplan of required validation actions, documentation, and filings along with an estimated timeline for achieving key milestones
    b. Secure needed advisory and legal services
    c. Develop required bond documentation for City Council approval to initiate the validation process which would allow the City to move quickly if it decides to issue POBs at a future date
2. Conduct other preparatory work that will enable the Council in 2021 to make a fully informed decision about the merits and risks of this option as a means of reducing our multi-billion-dollar unfunded actuarial liability with an arbitrage strategy in a very low interest rate environment, including:
    a. Complete research on the prevalence and performance of pension obligation bonds in other municipalities that includes contextual information on structures, sizing, risk considerations, credit implications, fiscal impact, and market conditions contributing to success or failure
    b. Study and report on the impact on the City's credit ratings in consultation with our advisors and review of rating metrics
    c. Perform a sensitivity analyses on the potential size of the bond issuance, assessing various risk tolerance levels and the projected cost-benefit to the City, including potential for series of bonds issued over time
    d. Assess the impact of different strategies for recognizing and applying the savings from the pension obligation bond strategy
    e. Conduct a public study session with the Council to fully vet questions and issues, and invite relevant consultants and experts to testify

f. If Council offers a favorable response after that study session, develop the required documentation for City Council to consider proceeding with the validation and subsequent authorization for the issuance of pension obligation bonds.

BACKGROUND

In my March Budget Message for Fiscal Year 2019-2020, I called for the convening of stakeholders to explore options that will both protect the benefits that our employees have earned, and protect the City's ability to provide basic services through the next recession. I urged that we conduct a series of public meetings because we have seen a deterioration of the funded position in both the Federated Plan and the Police and Fire Plan over the past 15 years, despite a series of measures that have successfully reduced benefits and long-term obligations—due to reductions in discount rates, poor investment returns, and changes in demographic assumptions. I wanted to explore potential solutions prior to the fiscal crisis that another recession could bring—and the timing was regrettably prescient. The Retirement Stakeholder Solutions Working Group (RSSWG) began meeting monthly in November 2019 and, after a hiatus due to COVID, reconvened this month.

In our recent October meeting, RSSWG explored using pension obligations bonds as a potential opportunity. Presentations were provided by our City's Finance Director, Julia Cooper,[1] and actuarial consultant, Cheiron.[2] The committee engaged in a robust discussion that appeared to favor further exploration of this concept.

State and local governments issue pension obligations bonds (POBs) to finance obligations in the retirement system, exploiting low borrowing costs of the bond issue to inject assets into the retirement system and capture investment earnings that exceed the lower borrowing rate on the bonds. In very simplistic terms, this amounts to investing on a margin account, and it raises very important questions of risk that need to be fully and publicly vetted before we move forward. Nonetheless, in an environment with extremely low interest rates by historic standards—borrowing costs for POB's would approach 3% today—the risks from this strategy have diminished and we have seen growing interest in this strategy. California local governments have issued more than $25 billion in POBs from 1985 to April 2020 with recent issuances occurring in cities such as Pasadena and Riverside.

We have explored using POBs in the past—most recently in 2010 when conditions were not favorable, and as a councilmember, I agreed at the time that the strategy presented too great a financial risk for the City. The market conditions we currently experience make this option safer and more promising today, and may well be even better in another 9-12 months, when the preparatory and legal work has been completed.

The critical path involves a validation action in Superior Court, taking at least several months where the pension obligation bond documents are validated by the court. In the event there is an appeal, the validation action process would be longer than several months. This process does not obligate the City to issue the bonds, but provides the City the flexibility to consider this option

[1] https://www.sanjoseca.gov/Home/ShowDocument?id=65229
[2] https://www.sanjoseca.gov/Home/ShowDocument?id=65251

any time in the future. Let’s provide ourselves, and future councils, with the best options, and the best information.