



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Julia H. Cooper

SUBJECT: COUNCIL STUDY SESSION
PENSION OBLIGATION
FINANCING

DATE: April 16, 2021

Approved

Date

4/16/2021

PURPOSE OF STUDY SESSION

To present and evaluate options on funding the City's Unfunded Actuarial Liability ("UAL") obligations of the City's two retirement plans ("Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan" and collectively, the "Plans"), including the possibility of issuing Pension Obligation Bonds ("POBs") as requested by the Mayor and City Council ("Council") in their December 1, 2020 referral, and provide other preparatory work that will enable the City Council to make a fully informed decision about the merits and risks of UAL financing options.

DESIRED OUTCOME OF STUDY SESSION

The Council, Administration, and stakeholders will have a shared understanding of:

- (a) why addressing the UAL and its budgetary impact on the City and its two retirement plans;
- (b) the risks and benefits of financing options available to address the UAL, and potential to mitigate those risks; and
- (c) the workplan and timeline required for achieving key milestones.

BACKGROUND

The City has been exploring options for controlling retirement costs including issuing POBs dating back to at least 2007. Commencing in October 2007, Mayor Reed formed 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, the City Manager released a report "General Fund Structural Elimination Plan" which included a summary of strategies to eliminate the General Fund Structural Deficit. One of those strategies

was issuance of POBs. In March 2010 in the Mayor’s Budget Message, as approved by the Council, the City Manager was directed to identify the potential benefits and drawbacks of POBs. In May 2010, the City Manager reported to the Council the conclusion of staff’s analysis:

- POBs were not a viable tool to address the 2010-2011 shortfall.
- If the Council wanted to assume the risk of financial loss from POBs, the general stock market conditions were not favorable.
- 6- to 12-month court validation action would have to be undertaken in 2010.
- It was imperative for Council to understand the market-volatility risks of POBs and potential financial losses to the City over the long term.
- These risks existed even with optimistic assumptions about the future average spread between bond interest costs and pension plan earnings.

Nine years later, Mayor Sam Liccardo, as part of his March 2019 Budget Message for FY 2019-20, recommended convening what became the Retirement Stakeholder Solutions Working Group (“RSSWG”) to address retirement fund resilience and explore options that would protect both employee benefits and the City’s ability to provide basic services through the next recession. Between November 2019 and February 2021, the RSSWG met nine times. At the October 13, 2020 meeting, the Finance Director provided a presentation on POBs. The final report of the RSSWG was issued on April 2, 2021¹ which included exploration of various avenues to reduce the City’s unfunded pension liability; one option explored was POBs. The RSSWG’s conclusions were that POBs Feasibility was “Achievable”, Cost would be “Determined over time”, Risk was “High”, and Difficulty was “Moderate”. Other than dedicating new taxes or existing revenues to pay retirement costs, (which were judged to be “unlikely” to be feasible) and highly difficult, the POBs were the only other option deemed by the RSSWG to have a “Significant” Impact on UAL.

On October 16, 2020, during a joint meeting of Council and the Retirement Boards, a presentation was provided by the Budget Director and Finance Director on Implications of COVID-19 to the City’s budget, including a presentation on POBs, as POBs may become an important strategy to mitigate the impact the retirement plans’ unfunded actuarial liabilities are having on the resources available to fund City services.

The Mayor’s memorandum² presented at the October 21, 2020 Joint Meeting for the Rules and Open Government Committee and Committee of the Whole (“Rules Committee”), item G.5 – Pension Obligation Bonds, recommended: (1) to initiate the process for possible issuance of POBs to fund unfunded actuarial liability of the Federated and Police and Fire Plans; and (2) to conduct other preparatory work that will enable the Council in 2021 to make a fully informed

¹ Information Memorandum to the City of San José City Council: Final Report of the Retirement Stakeholder Solutions Working Group Final Report, April 2, 2021
<https://www.sanjoseca.gov/home/showpublisheddocument?id=71005>

² <https://sanjose.legistar.com/View.ashx?M=F&ID=8856564&GUID=A70433AD-39C2-40BE-8124-E8A3A39281EE>

decision about the merits and risks of this option as a means of reducing the City retirement systems' multi-billion dollar unfunded actuarial liability with an arbitrage strategy in a very low interest rate environment.

The Administration submitted an Early Consideration Action form for the October 21 Rules Committee meeting. The "Criterion to Determine Scale of Project Complexity" scored 14, which signals the organization is not positioned to take on the additional work efforts related to POBs. Nevertheless, the Administration recommended a "green light", given the long lead time required to issue POBs and actions would need to commence in order for the City to be ready to take advantage of the current favorable market conditions. The City's current Tier I and Tier II UAL payments for the two Plans are projected to consume \$304 million of City expenditures in 2022 (assuming up front annual payments) and expected to peak in eight years to \$342 million in 2029, according to the actuarial reports of the two systems. Therefore, while the current effort to address UAL will be helpful for easing near-term budget challenges, issuing POBs to lessen the annual required contribution for the UAL may be one of the few tools available to prevent growth in pension expenses from impacting City services and support the funding of the two Plans.

The Rules Committee voted to have staff repeat the October 13 presentation to the RSSWG to the full Council at the December 1, 2020 meeting. On December 1, 2020³, the Finance Department provided an informational presentation to Council on the concept of POBs as requested by the Rules Committee, which also included background information and an overview of the City's Pension Plans.

After hearing the December 1, 2020 presentation, the Council provided explicit direction to the Administration, which included steps to prepare for and conduct a Study Session. As recommended by the Rules Committee, Council directed the following:

- A. 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:
 - Develop a workplan of required validation actions, documentation, and filings along with an estimated timeline for achieving key milestones
 - Secure needed advisory and legal services; and
 - Develop required bond documentation for 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

³ <https://sanjose.legistar.com/View.ashx?M=F&ID=8939982&GUID=6DCC6CFC-CA97-48E0-B587-3FAAA1979182>

- B. 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:
- 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;
 - Study and report on the impact on the City’s credit ratings in consultation with our advisors and review of rating metrics;
 - 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;
 - Assess the impact of different strategies for recognizing and applying the savings from the pension obligation bond strategy;
 - Conduct a public study session with the Council to fully vet questions and issues and invite relevant consultants and experts to testify; and
 - If Council offers a favorable response after that study session, develop the required documentation for Council to consider proceeding with the validation and subsequent authorization for the issuance of pension obligation bonds.

While preparing for a Study Session on POBs was not on the Administration’s workplan, staff immediately proceeded to prepare to respond to the Council’s direction. The Finance Department issued a competitive Request for Proposals for Municipal Advisor (“RFP”) in order to select one or more firms with experience evaluating pension obligation financings and advising municipalities. The engagement was split into two phases to ensure that the recommendation whether to issue bonds or not was not made by a firm with an economic incentive to have bonds issued. The Finance Department selected Urban Futures Inc., with offices in Tustin and Walnut Creek for Phase One. The Phase Two selection of the firm or firms to advise the City on the issuance of Bonds will be made if and when the Council directs staff to proceed with issuance of POBs or other retirement obligation financing. Concurrently, the City Attorney’s Office (“CAO”) concluded selection of the pool of firms with experience in public finance law, who will serve as Bond Counsel and Disclosure Counsel on the City’s various bond issues, including selection of a firm to help advise the City on legal matters relative to pension obligation financing. The CAO selected Stradling Yocca Carlson & Rauth, with offices in San Francisco and Newport Beach.

Since January, staff from the City’s Finance Department, Budget Office, Office of Employee Relations and CAO have been working collaboratively with UFI and Stradling to prepare for this Study Session, with weekly all-hands meetings to accomplish this work product in the short timeframe between December 2020 Council direction and the April Study Session.

On March 17, the Rules Committee set a City Council Study Session entitled Pension Obligation Financing Options for Friday, April 23, 2021 from 9:00 a.m. - 12:00 p.m.⁴ On April 14, the Rules Committee approved the Agenda⁵ for the Study Session.

AGENDA

The Study Session agenda will include presentations from staff from Finance Department, Budget Office and Office of Employee Relations, the municipal advisor, the bond counsel and a guest speaker, who is a highly regarded expert on public funds and retirement funds investing and has written extensively on pension fund financing and timing. It will also include question and answer session for Council discussion and a public comment session. City staff anticipates an in-depth discussion on the merits and risks of POBs, sensitivity analysis, answering questions from Council, and while no action by Council will occur at the Study Session, City staff will provide concluding remarks and potential next steps for Council to consider in the future. Study Session Agenda Topics will include:

- **Review of the UAL Problem** – City staff will provide an overview of the challenges of funding the UAL and past efforts by the City to provide funding solutions.
- **Pension Obligation Financing Options** – City staff will discuss various financing structures including POBs, provide background on POBs, provide the opportunity to hear a guest speaker on POBs and ensure Council is aware of both the benefits of issuing POBs and the counterpoint arguments against issuing POBs. Staff will also review information on the past performance of prior POBs.
- **Report from the City’s Municipal Advisor** – the City’s municipal advisor, will provide their analysis on POB issuance, discuss structuring options to mitigate risks of issuing POBs, and discuss selected case studies showing how past POBs have succeeded and other have failed to achieve intended results.
- **Analysis of Potential San José POB** – City staff will discuss City policy considerations and considerations in modeling future pension financing, and the City’s municipal advisor will specifically discuss POB structuring to address City policy considerations, POB stress testing and various financial models for POBs.
- **Next Steps** – While no action by Council is intended at the Study Session, City staff will provide concluding remarks and provide potential next steps for Council to consider.

⁴ <http://sanjose.legistar.com/gateway.aspx?M=F&ID=2413bb43-171a-4329-b62c-de5f697c0cbf.pdf>

⁵ <http://sanjose.legistar.com/gateway.aspx?M=F&ID=88666ff6-df43-4f45-973b-d9dcf66ec3e9.pdf>

To prepare for the Study Session, the following material is provided as attachments to this report:

- **Attachment A** is the Report of the Municipal Advisor
- **Attachment B** is a memo from Bond Counsel outlining the judicial validation process for POBs
- **Attachment C** is Girard Miller's biography (guest speaker)
- **Attachment D** is a select reading list of materials reviewed by staff and available for more detailed reading on the topic. These include publications that offer various perspectives on POB financing, including several articles authored by our guest speaker, Girard Miller

The presentation will be posted to the Council Agenda website the week of April 19 in advance of the Study Session.

ANALYSIS

The City has considered many options to address the UAL obligations of the City's two retirement systems. While the City has explored and implemented many options over the years to reduce retirement costs, POBs are being explored in the Study Session, at the Council's direction, as the last best option for making a significant impact on the City's large, \$3.5 billion, and growing, UAL. The goal of the Study Session is to provide City Council with information for consideration (including budgetary impact, risk/benefits, and workplan/timeline) about the merits and risks of UAL financing options in response to Council's December 1, 2020 direction to staff. The objective is to provide the basis for making future decisions as no Council decisions or actions are will occur at the Study Session.

During the review of the attached reports and suggested supplemental reading there are several key points to consider:

- Positive Impacts for City
 - Depending on how much of the Pension Obligation is refinanced with POBs, reduce the City's annual payments to paydown Pension UAL
 - Issuance of POBs involves replacing a portion of the Tier I UAL payments made by the City, with fixed debt service payments
 - Work towards mitigating and eliminating UAL contribution increases from rising through 2029 as currently projected, and eroding capacity for funding City programs and services
 - Use budgetary savings to accelerate the amortization of unfunded liability
 - Use some budgetary savings to ease current budget pressures
- 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 if the City elects to fund UAL over time with several bond issues

- Increase the funding level of the Federated and Police and Fire plans
- Reduce reliance on City Contributions.

Proposed Next Steps for City Council's Consideration

While no recommendation is being presented for Council deliberation at the Study Session and Council will have multiple future decision opportunities, staff offers the following next steps for consideration following the Study Session:

- Return to Council for formal direction at May 11 Council Meeting including any follow-up from the Study Session
- Return to Council to authorize validation and approval of bond documents, June 29 Council Meeting, if so directed on May 11
- Return to Council to approve specific financing plans and the accompanying offering document (Official Statement), following favorable validation judgment
- Judicial validation makes the tool available but does not commit Council which will need to authorize any future bonds separately

Potential Council direction on May 11:

- Direct staff to proceed with preparation of bond documents and court validation documents
- Direct preparation of Council Pension Obligation Fund Policy for Council review and approval
- Direct scheduling of joint meeting with Council and Retirement Boards to develop understanding of Retirement Board investment strategy for the POB bond proceeds to be received from the City and impact on UAL with infusion of POB proceeds
- Select remaining financing team members
- Use timing of validation to refine strategy, bond sizing, tranches and timing, based on prevailing bond and investment market conditions
- Return to Council for approval of specific bond financing plans if and after the bonds are successfully validated

EVALUATION AND FOLLOW-UP

Staff will return to Council on May 11, 2021 for Council direction on whether to proceed with the next steps in the process for the issuance of pension obligation bonds which includes the preparation of bond documents and court validation documents. If Council decides to move forward with issuing POBs, staff will work with bond counsel to prepare the material required for judicial validation that will be presented at the June 29, 2021 City Council meeting for Council approval. As outlined above, several Council approvals and discussions with retirement boards would be held before proceeding with any POB issuance. Due to the timing needed for

the judicial validation process, staff will continue to review and assess prevailing bond market and investment market conditions to determine whether POBs remain economically viable options to fund the City's UAL.

PUBLIC OUTREACH

This memorandum will be posted on the Council Agenda website for the April 23, 2021 Council Study Session. Due to the volume of information from the attachments listed below, each will be posted separately on the Council Agenda website.

COORDINATION

This memorandum was coordinated with the City Attorney's Office, City Manager's Budget Office, and Office of Employment Relations.

/s/
JULIA H. COOPER
Director of Finance

For questions, please contact Julia H. Cooper, Director of Finance, at (408) 535-7011 or via email at julia.cooper@sanjoseca.gov.

Attachment A – Municipal Advisor's Report

Attachment B – Bond Counsel Memorandum on Validation Process

Attachment C – Girard Miller Biography

Attachment D – Recommended Pre-Study Session Reading Materials for City Council