CITY COUNCIL AGENDA: 05/11/2021
ITEM: 3.4

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: CITY COUNCIL

FROM: Councilmember Matt Mahan

SUBJECT: **Actions Related to Continued Exploration of Pension Obligation Funding Strategies**

DATE: May 10, 2021

APPROVED: Matt Mahan

RECOMMENDATION:

1. In order to thoroughly understand the risks involved with issuing pension obligation bonds (POBs), direct the City Manager to highlight, in Fall 2021, a detailed POB risk and benefit analysis that includes a long-term, year-by-year projection of the potential impacts on the unfunded actuarial liability (UAL) and General Fund contributions toward the UAL, of both issuing and not issuing substantial POBs under the following market scenarios:
    a. Investment expectations are met (i.e. the 6.625% discount rate),
    b. A severe market downturn akin to 2001/2002 or 2007/2008,
    c. Prolonged underperformance (achieving 4 to 5% returns every year),
    d. And more generally, a best case and worst case scenario.

BACKGROUND:

I would like to thank City staff for their highly informative presentation at the April 23rd study session and for their ongoing exploration of various options for addressing the City's growing UAL. Unfunded retirement obligations are a long-standing challenge in San José and, despite the sacrifices made by taxpayers and city employees alike under the 2016 Measure F framework, it is clear that our UAL will continue to erode investment in city services for years to come. New solutions deserve serious consideration, but they also require the greatest possible scrutiny given the inherent risks and the severe consequences of a poor decision.

I would like to highlight for my colleagues that POBs do not address the UAL on a systemic level. While they enable an immediate infusion of borrowed money that our retirement funds can invest alongside the City's and employees' standard contributions, our underlying structural limitations—i.e. an overly optimistic assumed rate of return and contractual, lifetime obligations that steadily grow irrespective of fund performance—persist. We are legally bound to the same expectations, obligations, and investment limitations, but this time we are betting that our investments will beat expectations.

I, for one, am skeptical that POBs represent an opportunity for arbitrage, as was stated during the Council study session. The investors on the other side of this transaction are willing to purchase low-interest bonds because other asset classes currently present a level of risk (i.e. uncertainty of outcome) that they do not find more attractive. POBs simply allow the City to trade low-risk, low-return debt for high-risk and *potentially* high-return investments. There is no free lunch.

Therefore, I would like to quantitatively understand the risk and potential outcomes we would assume by issuing POBs. What is the worst case scenario? What is the best case scenario? What are some reasonably high-probability scenarios in-between that reflect circumstances we are all too familiar with, such as a 2007/2008-style recession in the early years of the bond or sustained low performance that is at least one or two percentage points below our assumed rate of return?

The analysis from staff on these scenarios should ideally show year-by-year assets and obligations estimates for at least the following: market value assets of the pension fund, actuarial liability, unfunded liability on a market value basis, outstanding principal on the POBs, and the sum of unfunded liability plus outstanding principal. In addition, each scenario should aim to include inflow and outflow estimates year-by-year for at least the following: employer normal cost, employer supplemental cost for the pension fund, the sum of employer normal cost plus supplemental cost (total employer contributions to the pension fund), principal payments on the POBs, interest payments on the POBs, the sum of principal plus interest (total debt service on the POBs), and the sum of total employer contributions plus total debt service on the POBs. These distinct year-by-year projections under different assumptions would allow my colleagues and me to ultimately make the most informed decision possible for the City's future.

Thank you again to city staff for exploring new solutions. Despite my concerns with POBs, I truly appreciate your focus on this important issue and the many possibilities you've already evaluated. I look forward to learning more about POBs as my colleagues and I assess if the potential benefits outweigh the risks.