Livermore Area Recreation and Park District

Pension Obligation Bonds Analysis

April 2021

ITEM NO. 4.1

Defining the Problem

- Unfunded accrued liabilities (UAL) are driving up pension costs for special districts, cities and counties in California and are projected to significantly increase over the next ten years.
- The increased costs are causing local governments to divert monies from basic government services to pay for benefits.
- The effects of the COVID-19 crisis on both revenues and pension funding levels will exacerbate these challenges.

Alternatives

- What are the alternative policy solutions to address the problem:

Consistent Budgetary Funding
- Pay Down UAL with Reserves
- Establish Pension Rate Stabilization Trust

Increase Revenues
- Pass Revenue Measure to Support Operating Cost or Bond Measure for Capital Expenditure

Manage Benefit Liabilities
- Increase Employee Pension Contributions
- Reduce Benefits for New Hires

Build Fund Assets
- Issue **Pension Obligation Bonds**
- Asset Monetization

What Are Pension Obligation Bonds

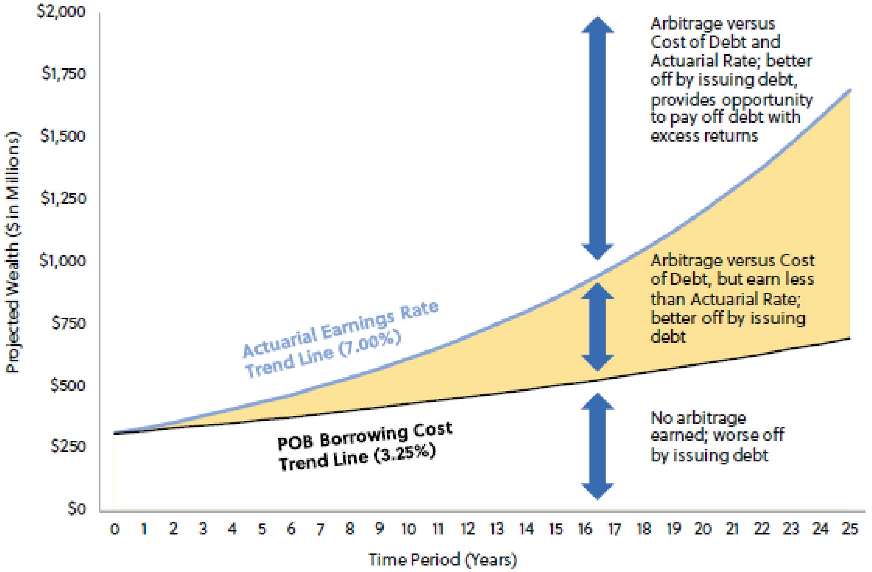
- Taxable bonds issued by state or local governments to fund an unfunded pension liability.
- The objective of issuing pension obligation bonds is to **reduce** the required employer contributions needed to meet its pension costs.
  - POBs alone will not likely solve the local government's pension and budgetary issues.
  - Growth in salaries will create increases to the UAL.
  - The actual savings produced by issuing POBs, if any, will not be known until the bonds mature.

Basic Mechanics

- The local government issues taxable debt at an interest rate below the actuarial earnings rate of the pension fund.

- As a result of the rate differential, the debt service on the bonds is expected to be less than the UAL annual cost.

- What would have been the local government's UAL annual cost is replaced by debt service.



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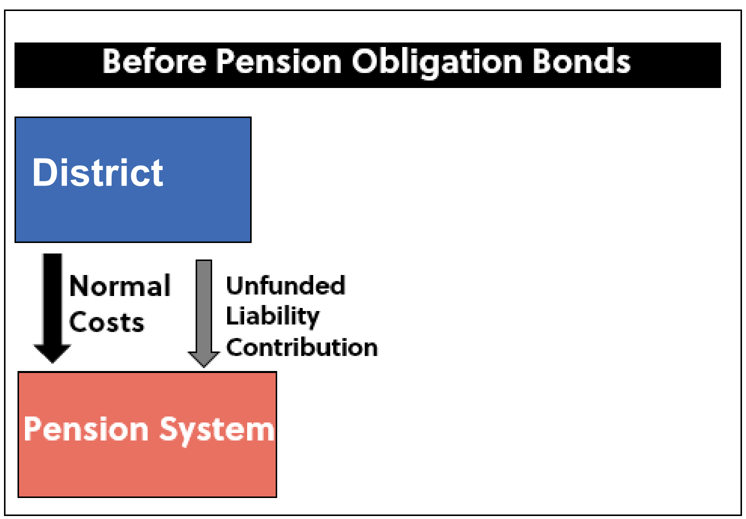
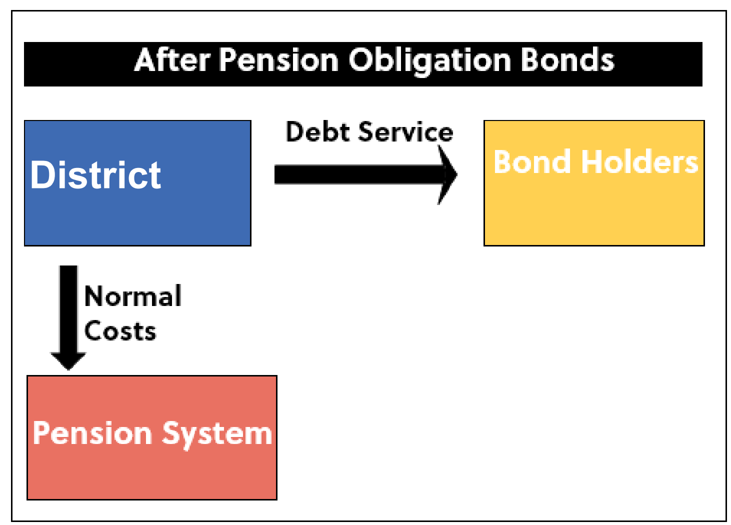
POB Proceeds Deposited with Pension System

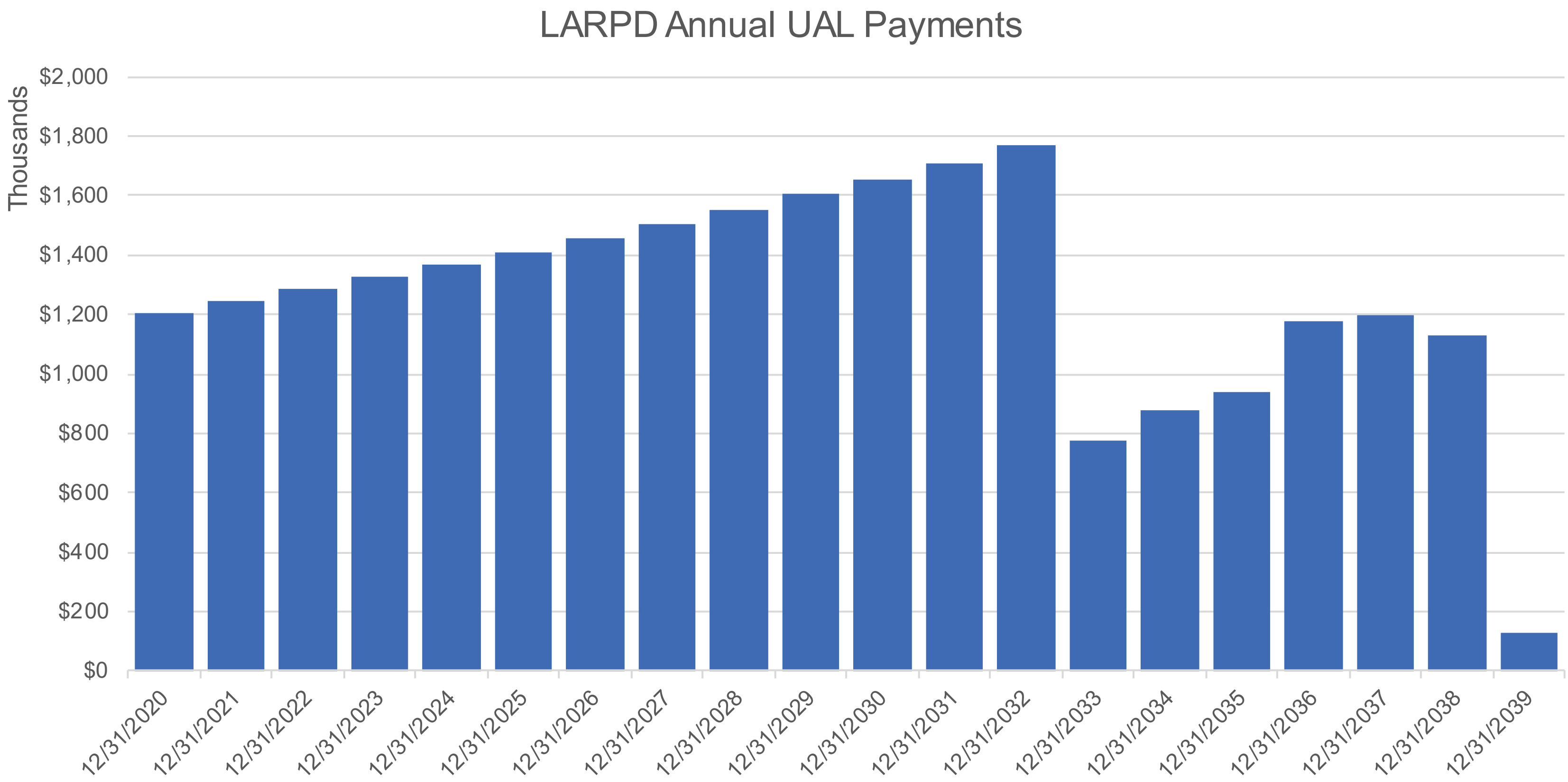
- Proceeds of the POBs may be paid directly to the pension system
  - The local government pays down all or a portion of its actuarially determined liability as defined by GASB.
  - The annual UAL payment is reduced or eliminated.
  - Instead of making UAL payments, the local government entity makes debt service payments.





LARPD Unfunded Liabilities

- LARPD's anticipated future UAL payment schedule, based on the 12/31/19 valuation with updated assumptions applied as of December 2020, is shown below.



Amortization Bases

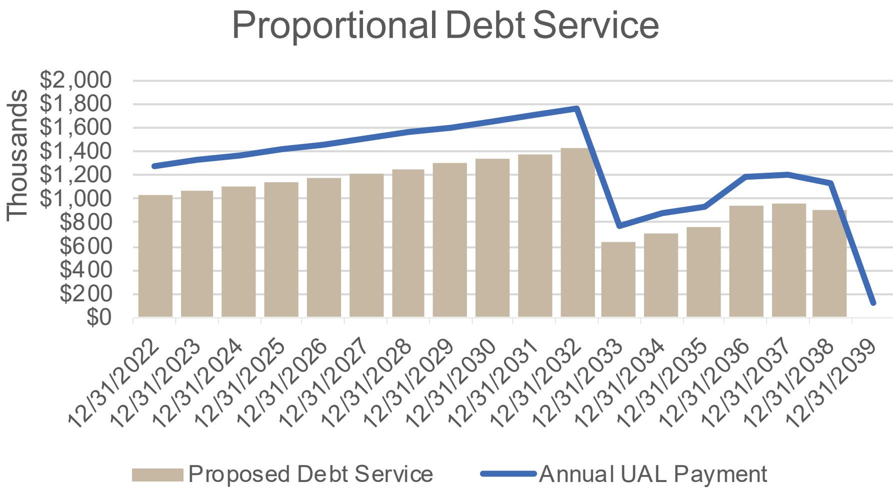
- A local government's Unfunded Accrued Liability (UAL) is made up of bases, which represent contract amendments, actuarial assumption changes, method changes, and investment gains or losses.
- Each base is separately amortized and paid for over a specific period of time.
- Each year new bases are added.
- Bases drop off the schedule as they are paid off.

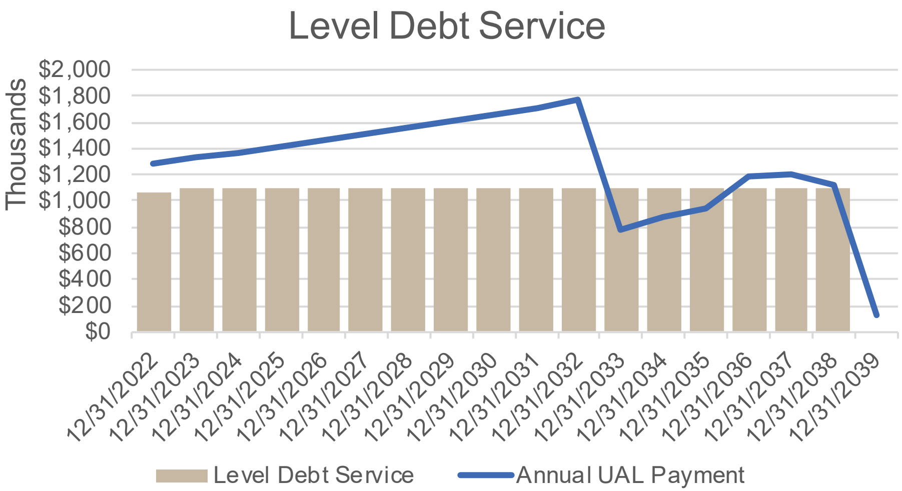
LARPD Plan Amortization Bases

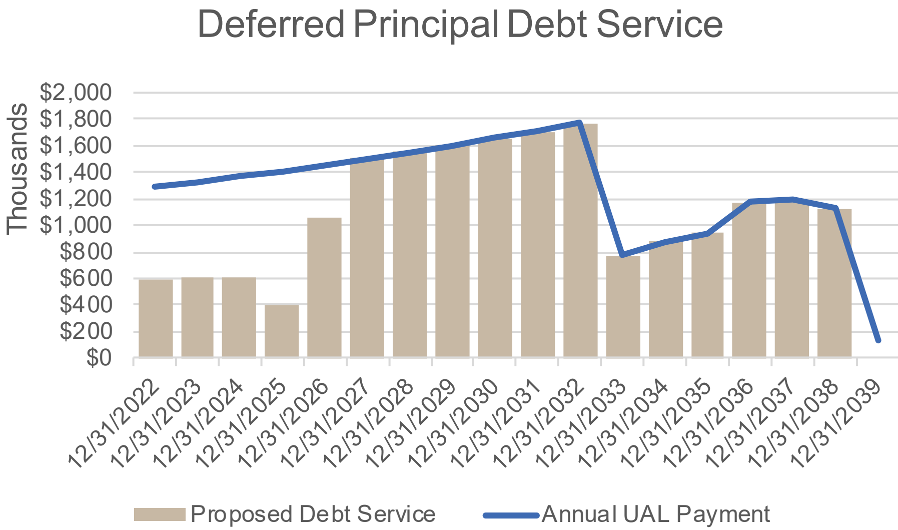
- Local governments can select which bases they want to fund.
  - The bases with shorter amortization periods will produce greater savings in the short term versus longer bases, but smaller overall savings.

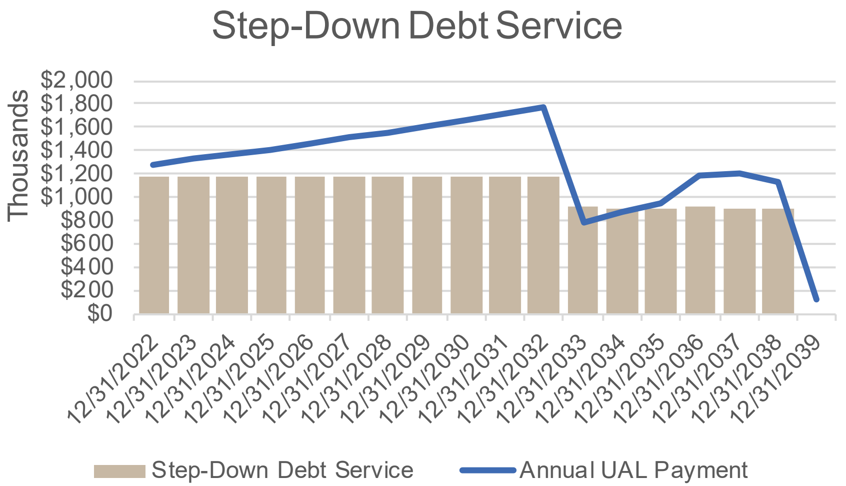
Type	Date Established	Initial Amount ($ in '000s)	Initial Period	Outstanding Balance ($ in '000s)	Years Remaining	2020 ($ in '000s)
Combined Bases	December 31, 2011	$7,060	21	$6,502	12	$679
Experience Loss	December 31, 2012	370	20	338	12	35
Experience Gain	December 31, 2013	(534)	20	(501)	13	(49)
Experience Gain	December 31, 2014	(1,562)	20	(1,493)	14	(138)
Change in Assumptions	December 31, 2014	1,303	20	1,245	14	115
Experience Gain	December 31, 2015	(1,506)	20	(1,462)	15	(128)
Experience Loss	December 31, 2016	139	20	137	16	11
Experience Gain	December 31, 2017	(622)	20	(615)	17	(49)
Change in Assumptions	December 31, 2017	1,418	20	1,402	17	112
Experience Los	December 31, 2018	1,058	20	1,053	18	81
UAAL for Tier 1 members	December 31, 2018	6,576	20	6,543	18	502
Experience Loss	December 31, 2019	980	20	979	19	72
Experience Gain	December 31, 2020	(2,024)	20	(2,024)	20	(144)
Change in Assumptions	December 31, 2020	1,171	20	1,171	20	83
Subtotal				**$13,275**		**$1,182**

POB Structuring Options









POB Structuring Options Detail

- The table below compares the effective interest rate, annual debt service, and savings between the four alternatives.
  - The figures are based on the December 31, 2019, valuation report.
  - Includes a 35 bps cushion over current interest rates.

Structure	Proportional	Level	Deferred Principal	Step-Down
Par Amount	$14,480,000	$14,480,000	$14,480,000	$14,480,000
TIC	3.00%	3.08%	3.10%	3.01%
Average Annual Debt Service	$1,078,628	$1,098,718	$1,124,422	$1,077,153
Gross Savings	$4,416,332	$4,074,799	$3,637,831	$4,441,402
Present Value of Savings	$3,463,961	$3,353,098	$3,324,992	$3,453,726

Factors to Consider

- Depositing POB proceeds into ACERA to bring the UAL to zero doesn't necessarily keep it at zero in the future.
- POB issuers can choose to address only a portion of their UAL.
  - The shorter UAL bases are often funded to produce greater short-term savings.
- Reaching a certain funded ratio is not necessarily the objective.
- Issuing POBs changes the character of the obligation by replacing a so-called "soft debt" (the pension liability) with a "hard debt" (bond indebtedness).
  - Paradoxically, recent bankruptcy opinions in the last decade have indicated the opposite effect, treating bondholder rights below those of retirees and pension plans.
- Credit rating implications:
  - Main concern is the implementation of an overall plan to address unfunded liabilities.

Potential Disadvantages

- The GFOA recommends that state and local governments do not issue pension obligation bonds.
  - *"POBs involve considerable investment risk…"*
- **If the pension investment return rate falls below the interest rate on the bonds, the local government will have been worse off by issuing debt.**
- Lump sum investment into market – concentrating risks.
- The pension fund could exceed it investment targets, causing the fund to be over funded – borrowed too much.

Recent California Pension Obligation Bond Issuances

- Over 25 POBs have been issued by cities, counties, and special districts in California since early 2020.
  - Total of over $3.95 billion.
  - Many more are currently in progress.

Issuer	Sale Date	Principal Amount
Corte Madera	4/28/2021	$19,000,000
Manhattan Beach	4/28/2021	91,000,000
Huntington Beach	3/16/2021	363,645,000
Orange (City of)	3/3/2021	286,485,000
Chula Vista	2/11/2021	350,025,000
Downey	2/9/2021	113,585,000
Monterey Park	2/2/2021	106,335,000
El Cajon	1/13/2021	147,210,000
Coachella	11/19/2020	17,590,000
Gardena	11/10/2020	101,490,000
Arcadia	10/27/2020	90,000,000
Azusa	9/17/2020	70,105,000
Pomona	8/13/2020	219,890,000
San Bernardino (City of)	7/15/2020	19,850,000
Kensington Police Protection and CSD	6/18/2020	4,544,000
North County Fire Protection District	6/11/2020	20,305,000
Carson	6/10/2020	108,020,000
El Monte	6/9/2020	118,725,000
Riverside (City of)	6/4/2020	432,165,000
Inglewood	6/2/2020	101,620,000
Grass Valley	6/1/2020	18,311,000
Montebello	5/27/2020	153,425,000
Ontario	5/12/2020	236,585,000
Larkspur	4/30/2020	18,295,000
Riverside County	4/22/2020	719,995,000
Richardson Bay Sanitary District	2/28/2020	2,383,000
Pasadena	2/5/2020	131,800,000

Framework

How to Evaluate POBs as an Alternative

- Is there a multi-prong strategy to address the rising pension costs?
- Is there an arbitrage opportunity?
- Is the local government in a financial position to withstand the investment risk?
- Are equities on an upswing from a recession/low point?
- Is the probability of success sufficient?

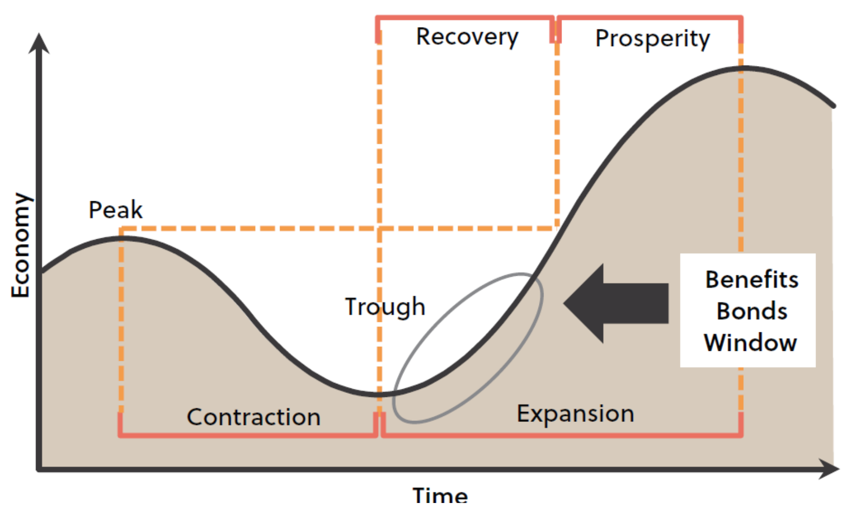
Financial Health

- If investment returns are not realized, is the local government in a financial position to cover increased unfunded liability payments and debt service?
  - For example:
    - Maintenance of a pension stabilization fund.
    - Strong available general fund reserves (typically greater than 15% of expenditures).
      - Projected maintenance of strong reserves.
      - Minimum general fund reserve policy.
    - Revenues have generally increased year-over-year for the past ten years.
    - Operations are generally balanced without the use of reserves.

The Benefit Bonds Window

- Is the "benefit bonds window" open?
  - Based on historic market patterns, this relatively uncommon capital markets "window" is likely to arise:
    - once a recession begins to reach its bottom,
    - at a time when interest rates are relatively low (producing market liquidity and growth), and
    - when stock prices are still depressed on a long-term valuation basis.

Exhibit 5: The Benefit Bonds Window Within the Economic Cycle



The Benefit Bonds Window

- It is during these periods when benefit bond issuance could offer the highest probability of both near- and long-term success.
- While issuing within a benefit bonds window improves the probability of success, it does not assure success.
- The benefit bonds window is only quantifiable in hindsight. No one can predict in real-time when there is a market bottom.

POBs – Probability of Success

- PFM can assist the District to evaluate the probability of success of a POB financing.
  - "Success" in this analysis means the total financial benefit (asset balance in the pension fund minus payments to ACERA or POB debt service) is higher with issuance of POBs than without.
- This analysis can evaluate the probability that a POB will benefit the District financially over a specified time horizon.

Logistics

Timeline

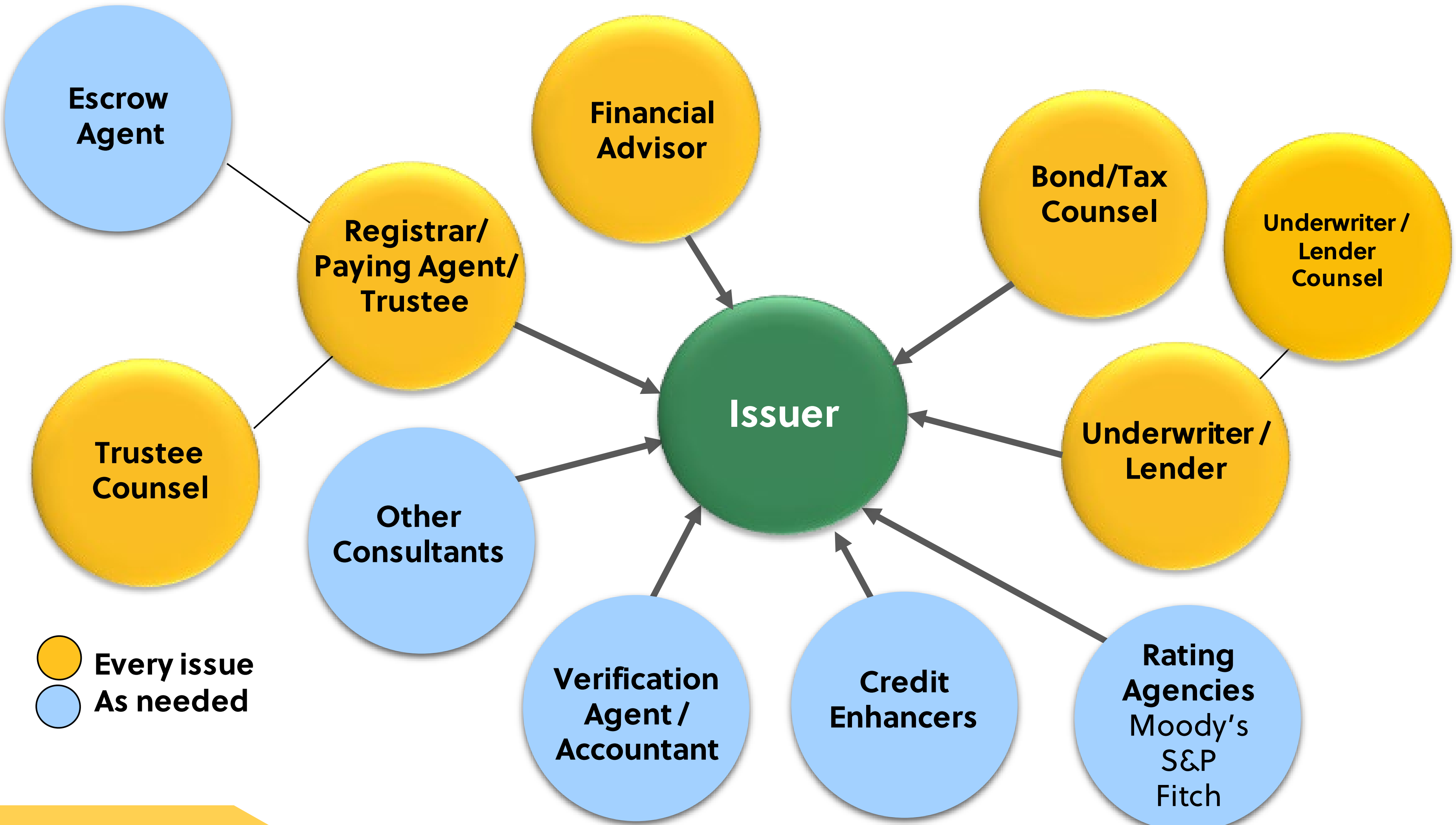
- The Pension Obligation Bonds issuance process takes approximately three months.

Date	Activity
Week of May 10th	Distribute draft legal and disclosure documents
Week of May 10th	Receive 12/31/20 amortization schedules from ACERA
Thursday, June 10th	Present legal and disclosure documents to Board for approval
Week of June 14th	Receive bond rating.
Week of June 28th	Bond sale - establish interest rates
Week of July 12th	Closing - District receives funds

Legal Authority to Refund Pension Debt

- Government Code section 53583 (a) allows any local agency to issue bonds for the purpose of refunding any of its Revenue Bonds
- Special Districts are a “local agency” (GC section 53580)
- “Revenue Bonds” are defined to include “Bonds, warrants, notes, or other evidence of indebtedness of a local agency” payable from non-ad valorem property taxes (GC section 53570(b)(1)
- Courts have specifically held than an obligation to make an annual contribution to PERS is an indebtedness and that “indebtedness” is “traditionally understood [to] cover obligations under a pension plan.”

Financing Team Participants



Appendix

GFOA View on Pension Obligation Bonds

- In January 2015, the Government Finance Officers Association (GFOA) issued an advisory recommending against the issuance of POBs, citing the following concerns:

1. Reinvestment risk

POB performance is affected by the performance of the pension fund into which the proceeds are deposited. PFM can assist the District to analyze this risk and evaluate the probability of achieving a financial benefit through the issuance of POBs.

2. Use of structured products and derivatives, introducing counterparty, credit, and interest rate risk

The District does not need or intend to engage in GICs, swaps, or derivatives in connection with POBs; any POB transaction would be issued as fixed rate bonds.

Source: GFOA Pension Obligation Bonds Advisory, https://www.gfoa.org/materials/pension-obligation-bonds

GFOA View on Pension Obligation Bonds, continued

3. Increased debt burden, use of debt capacity, and inflexible prepayment terms

POBs are now commonly issued with a 10-yr call option.

4. Deferral or extension of repayment

The District does not intend to extend repayment of its pension liability through a POB.

5. Negative credit rating impact

S&P has stated: "We consider debt, pension, and OPEB expenses to be fixed costs. Unless there is credible action to reduce pension or OPEB benefits, we treat the liabilities as hard debt that must be paid." If paying off the UAL with POBs reduces the District's total liabilities and future payments, it may be credit neutral or even a credit positive. POBs can be a part of a comprehensive long-term pension funding plan.

Source: GFOA Pension Obligation Bonds Advisory, https://www.gfoa.org/materials/pension-obligation-bonds

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