



City of La Habra

Pension Obligation Bond Options Analysis and Review

April 8, 2021

Table of Contents

Section

- I. History of City of La Habra Pensions
- II. Review of Pension Obligation Bonds
- III. Primer on Risks/Benefits of Pension Obligation Bonds
- IV. Recommendation

Section I

History of City of La Habra Pensions



City of La Habra Pension Plans

- Most cities in California, including La Habra, contract with CalPERS for their employees' retirement benefits.
- CalPERS provides for and manages the City's employee pension plans.
- La Habra has 2 CalPERS pension plans:
 - ◆ Safety Plan (Sworn)
 - Classic Members (members prior to 1/1/12): 3% at 50
 - Tier II Members (members between 1/1/12 and 12/31/12): 2% at 50
 - PEPRAs Members (members on or after 1/1/13): 2.7% at 57
 - ◆ Miscellaneous Plan (Non-sworn)
 - Classic Members (members prior to 1/1/12): 2% at 55
 - Tier II Members (members between 1/1/12 and 12/31/12): 2% at 60
 - PEPRAs Members (member on or after 1/1/13): 2% at 62

Info About City of La Habra Plan

# of Members As of 6/30/2019	Safety	Misc.	Total
Active Members	68	246	414
Transferred Members	52	204	256
Terminated Members	17	267	284
Retired Members	<u>195</u>	<u>304</u>	<u>499</u>
TOTAL	332	1,121	1,453

Active Members: Current employees enrolled in CalPERS

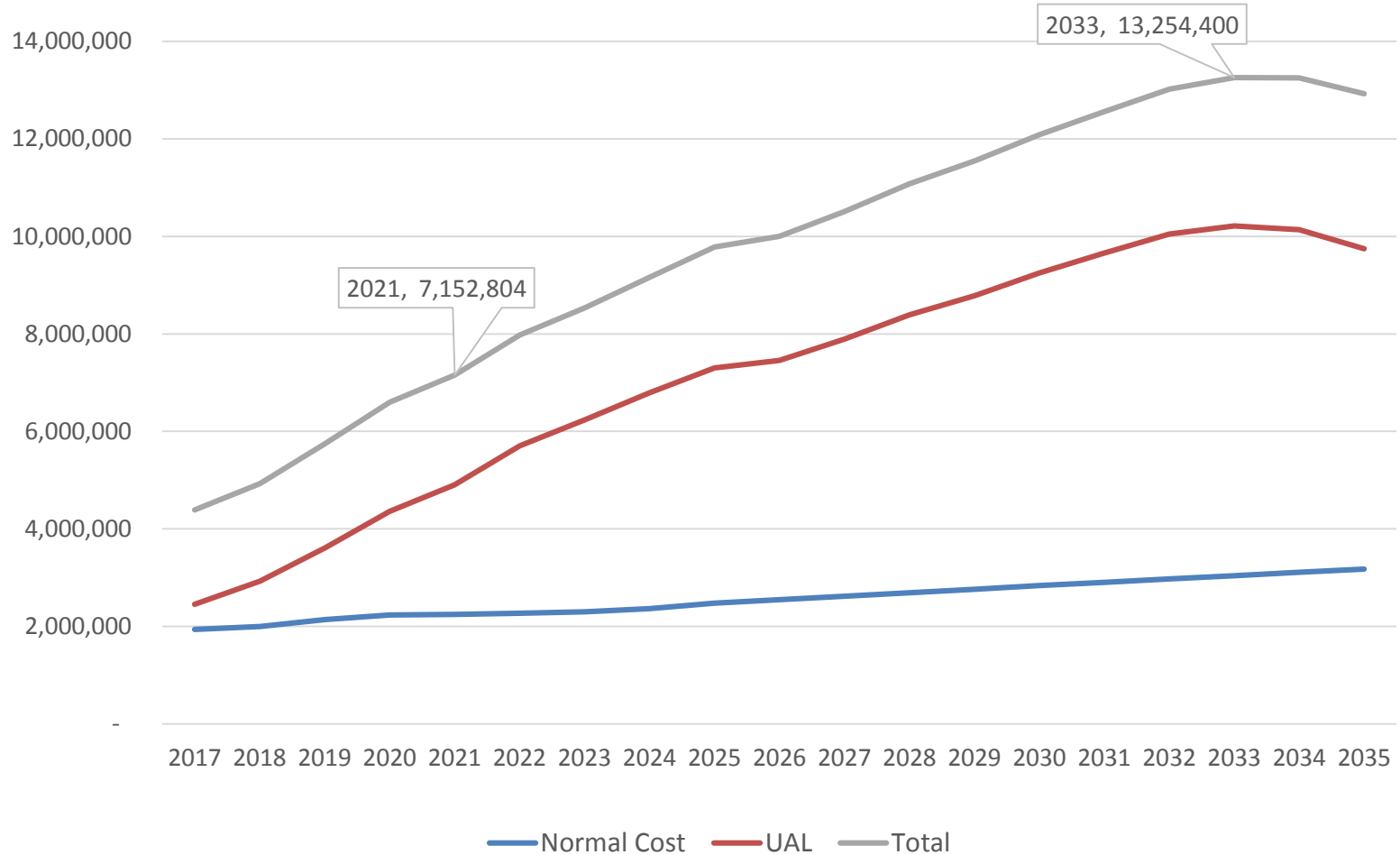
Transferred Members: Former employees that are still employed at another CalPERS employer. On the Miscellaneous side, this also includes former Police Academy Trainees that are initially miscellaneous members prior to being sworn in as officers.

Terminated Members: Former employees that are not working at another CalPERS employer and are not retired.

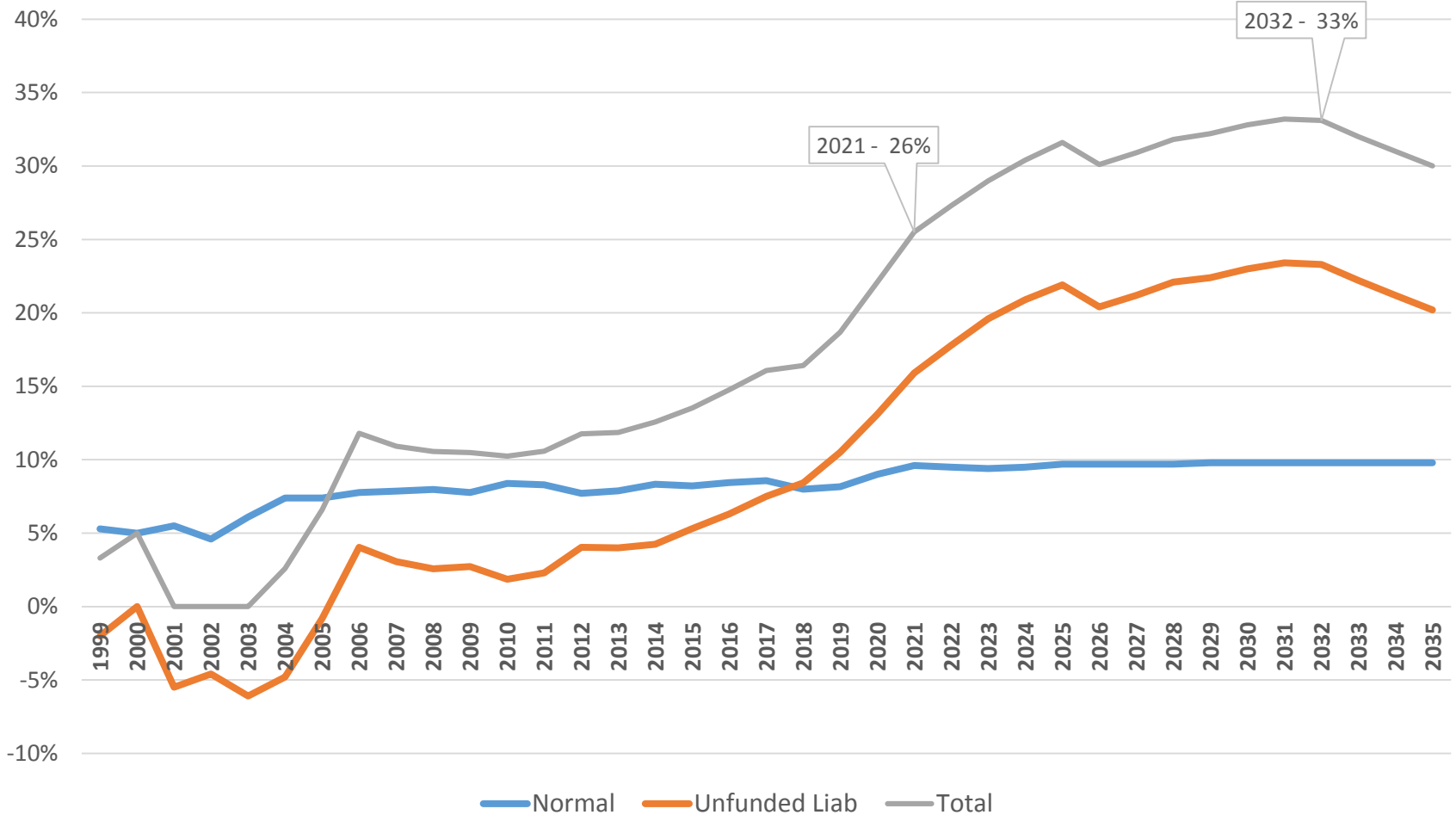
Retired Members: Former employees that are now retired from the CalPERS system. Does not necessarily mean they retired from the City of La Habra.

Projected Pension Contribution

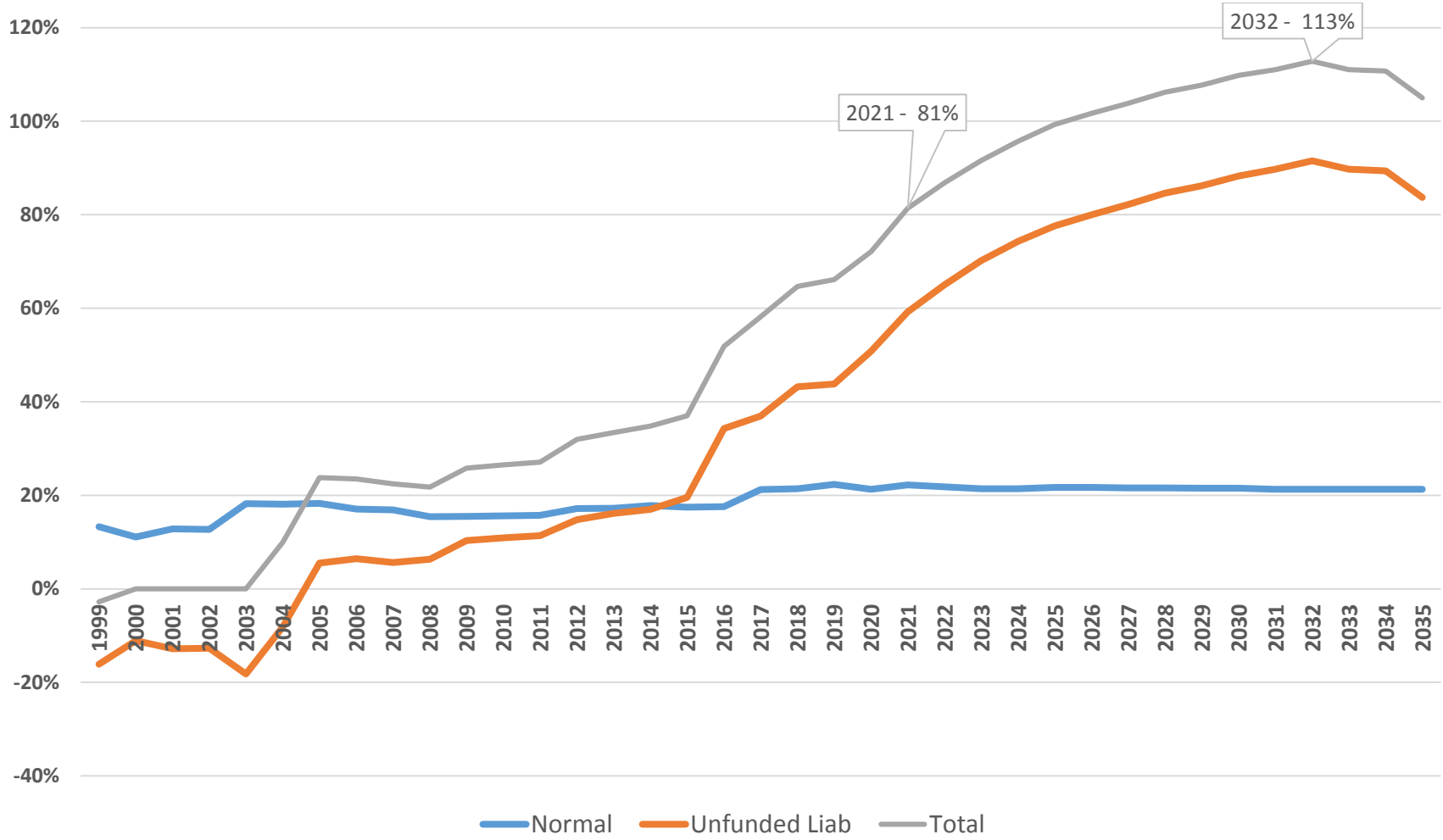
Estimated General Fund Pension Costs (\$)



Pension Contribution Rates (as % of Payroll) Miscellaneous Plan



Pension Contribution Rates (as % of Payroll) Safety Plan



Safety Side Fund Liability

Safety Side Fund Liability

- ◆ In 2005, the City outsourced fire operation to LA County Fire Dept.
 - City's Safety Plan was terminated as required by State Law since the number of active safety members dropped below 100 (Police only)
 - Members were required by CalPERS to join State-wide Cost-Sharing Pool
 - Side Fund was created to account for the difference between funded status of the pool and former plan
 - Side Fund balance as of June 30, 2019 is approximately \$5.9 million.
 - 14 Years Amortization remaining at 7% per year interest

Enacted Pension Solutions

- July 2010 – City Council established lower cost pension plans (Tier 2)
- January 2013 – CalPERS Pension Reform Act took effect (PEPRA)
- June 2018 – City Council established a Section 115 Trust (Pension Rate Stabilization Fund)
- July 2018 - Secured agreements from employee bargaining units to have employees contribute towards the City's pension “employer” rate through cost sharing agreements

Section II

Review of Pension Obligation Bonds



What are Pension Obligation Bonds (“POB”)?

- Taxable form of debt issued by governmental employers to retire all or a portion of their Unfunded Accrued Liability (“UAL”) with the goal of reducing future liability
- Designed to take advantage of an “arbitrage” opportunity whereby the issuer borrows at a lower rate in the fixed income market than what can be earned by investing bond proceeds at a higher rate in the pension fund (a balanced portfolio), including a variety of investment vehicles, predominantly equity investments
 - ◆ Interest is not exempt from federal income tax due to arbitrage structure
- POB debt service payments would replace the refunded UAL payments
 - ◆ Does not factor in City’s need to continue making 100% of its normal cost payments and remaining UAL payments not funded with POBs
- California’s State Constitution does not specifically authorize POBs
 - ◆ Legal foundation to issue is based on statute to refinance existing debt
 - ◆ Validation action is needed to officially confirm the existence of a pension liability with the local County Superior Court to obtain authorization to issue POBs
 - Process takes approximately 3 months

What are Pension Obligation Bonds (“POB”)? (Cont.)

The Court Validation Process

- POBs fall under an exception to the constitutional debt limit because of a public agency’s obligation to fund its pension system payments.
- Bond counsel requires that POB documents are “validated” in Superior Court.
- Validation **does not** obligate the City to issue bonds, nor even to have agreed on a specific plan of finance.
- First step in the validation process is the preparation of bond documents. The documents can be prepared with maximum flexibility regarding bond structure and terms to position the City to move quickly if it decides to issue POBs at a future date.
- Validation action generally requires approximately 90 days from the date of filing, and an additional 30-day appeal period.

What are Pension Obligation Bonds (“POB”)?(cont.)

- Placentia, West Covina and Torrance Alternate Model
 - ◆ Issuance of Taxable Lease Revenue Bonds to avoid the filing of a judicial Validation Action in Superior Court
 - Recent challenges by Howard Jarvis Taxpayers Association (“HJTA”) (i.e. Simi Valley and West Covina)
 - Requires the City to encumber an asset to secure the Bonds (City owned streets, facilities, etc.)
 - Allows the POB issuance time-line to be accelerated should the City decide to move forward

What are the Potential Benefits Associated with POBs?

- **Initial Reduction in UAL** with magnitude of reduction determined by percentage of UAL funded with POBs.
- **Savings** achieved through lower debt service payments to bond holders compared to what the City would otherwise have been required to contribute to the pension plans in order to amortize the UAL.
- **Market timing** can have a positive impact on the long-term economics of a POB program. Investment gains above the bond yield early in the term of a POB program result in a pension system “surplus” that provides a cushion against future market declines.
- **Time Value of Money** POBs accelerate the investment of funds, thereby increasing the compounding of earnings.

What are the Potential Risks Associated with POBs?

- **Investment risk (Arbitrage risk)** is the principal risk – if the pension 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.
- **Overfunding Risk** – Too high of a pension funding level may cause labor groups to ask for increased benefits from the new annual cash flow savings
- **Flexibility/Option Risk** - Flexible UAL liability is replaced with comparatively inflexible municipal bonds
 - ◆ Recent POB issuances have sold with a 10-year optional call
- **Credit Risk** – S&P Global Ratings views POB's in environments of fiscal distress or as a mechanism for short-term budget relief as a negative credit factor.
- **Political Risk**
 - ◆ An issuer may get a reputation for being too risky by gambling on future market returns; negative reputation due to well publicized bankruptcies (Detroit, Stockton & San Bernardino)
 - ◆ Government Finance Officers Association's (GFOA) website states that it **“recommends that state and local governments do not issue POBs”**

Government Finance Officers Association (GFOA) Pension Obligation Bond Advisory

Recommends state and local government do not issue POBs for following reasons:

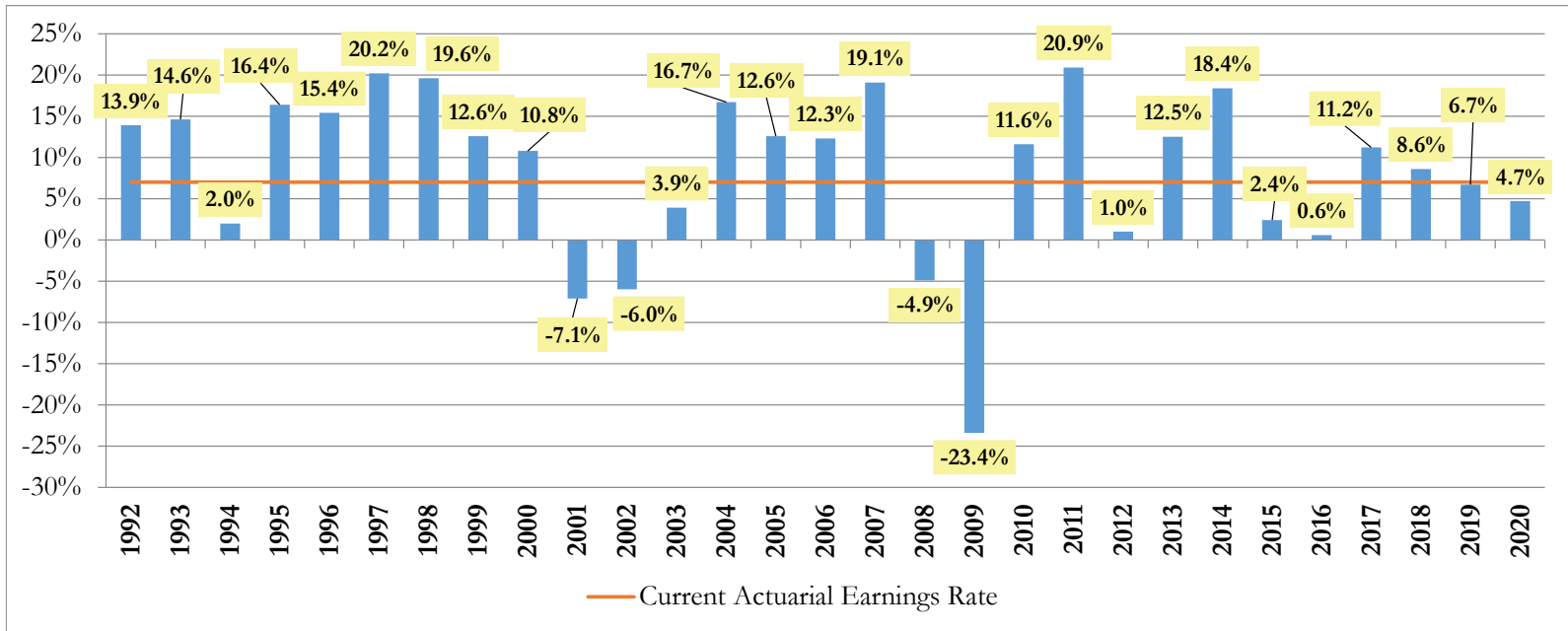
- Invested POB proceeds may fail to earn more than interest rate owed over bond term thereby increasing overall liabilities, rather than decreasing overall costs
- Complex POB instruments carry considerable risk especially if derivative products are utilized
- Issuing taxable debt increases jurisdiction's bonded debt burden potentially using debt capacity that could be used for other municipal purposes
- If POBs are structured with deferred principal amortization or repayment longer than actuarial amortization period overall borrowing costs will increase
- Rating agencies may not view as credit positive, especially if not part of more comprehensive plan to address pension funding shortfalls.

What Strategies can be used to Mitigate POB Risks?

- Issue less than 100% of the current estimate of the UAL.
 - ◆ Minimizes the lump sum amount invested at one time and avoids the budgetary pressures that could be caused from a potentially over-funded system.
- Consider issuing multiple POBs over multiple years, assuming favorable market conditions.
 - ◆ Represents a form of “dollar cost averaging” to help mitigate market timing risks.
 - ◆ Timing issuances at key Market Cycles (during low equity market cycles and low interest rate environment)
- Mitigation of market/credit risks
 - ◆ Ensure adequate spread between borrowing rate and assumed earnings rate.
 - ◆ Avoid riskier bond structures, such as variable rate debt and interest rate swaps.
- Be Prepared to Issue POBs, when time is right
 - ◆ Prepare financing documents, establish minimum savings target and wait for favorable market conditions.

Future Investment Earnings Is Key Variable

Historical PERS Rate of Return, and Interest Rates



- CalPERS Rates:
 - ◆ **Current Actuarial Earnings Rate Assumed at: 7%**
 - ◆ Historical Rate of Return over the past 30 years at: 8%
- 30 Year Treasury rate as of March 23, 2021 is 2.34%
- POB All-in True Interest Cost ("TIC") assumed at 3.78% to 3.89%
 - ◆ POBs are sold at a spread to treasuries

Recent POBs by other CA Cities

- Arcadia
- Azusa
- Baldwin Park
- Brawley
- Carson
- Chowchilla
- Chula Vista
- Coachella
- Downey
- El Cajon
- El Monte
- Gardena
- Glendora
- Hawthorne
- **Huntington Beach**
- Inglewood
- La Verne
- Larkspur
- Marysville
- Montebello
- Monterey Park
- Ontario
- **Orange**
- Pasadena
- **Placentia***
- Pomona
- Ridgecrest
- Riverside
- Torrance*
- West Covina*

* Structured as a Lease Revenue Bond.

La Habra Pension Funding Situation

- City contributes to 2 CalPERS benefit pension systems:
 - ◆ Miscellaneous Plan
 - ◆ Safety Plan
- City currently has an aggregate UAL of approximately \$91.7 million ¹
 - ◆ Combined normal cost and UAL annual payments have increased by 64% over the past five years

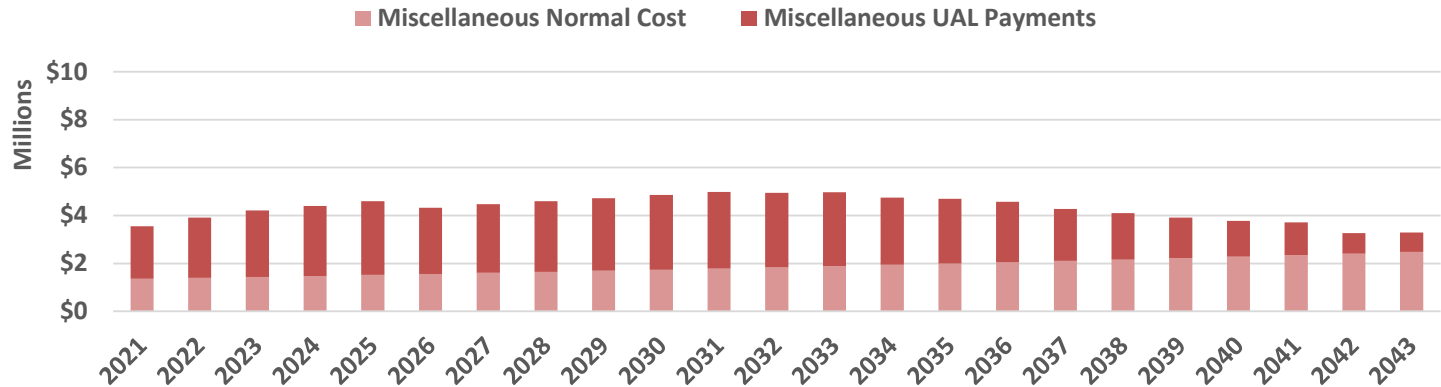
UAL Balance	6/30/2017	6/30/2018	6/30/2019	6/30/2020	6/30/2021	Increase	
Miscellaneous Plan	\$20,269,465	\$28,311,619	\$28,311,619	\$27,862,230	\$31,867,433	\$11,597,968	57%
Safety Plans	\$42,327,657	\$52,230,080	\$52,230,080	\$52,412,452	\$59,830,929	\$17,503,272	41%
Total	\$62,597,122	\$80,541,699	\$80,541,699	\$80,274,682	\$91,698,362	\$29,101,240	46%

UAL & Normal Cost Annual Payments	2017-18	2018-19	2019-20	2020-21	2021-22	Increase	
UAL							
Miscellaneous Plan	\$1,213,313	\$1,553,536	\$1,921,886	\$2,187,956	\$2,617,761	\$1,404,448	116%
Safety Plans	\$2,448,508	\$2,955,579	\$3,524,422	\$3,944,049	\$4,523,582	\$2,075,074	85%
UAL Total:	\$3,661,821	\$4,509,115	\$5,446,308	\$6,132,005	\$7,141,343	\$3,479,522	64%
Normal Cost							
Miscellaneous Plan	\$1,150,726	\$1,206,387	\$1,322,602	\$1,326,651	\$1,363,976	\$213,250	19%
Safety Plans	\$1,345,110	\$1,478,449	\$1,473,685	\$1,481,760	\$1,591,541	\$246,431	18%
Normal Cost Total:	\$2,495,836	\$2,684,836	\$2,796,287	\$2,808,411	\$2,955,517	\$459,681	18%
Total	\$6,157,657	\$7,193,951	\$8,242,595	\$8,940,416	\$10,096,860	\$3,939,203	64%

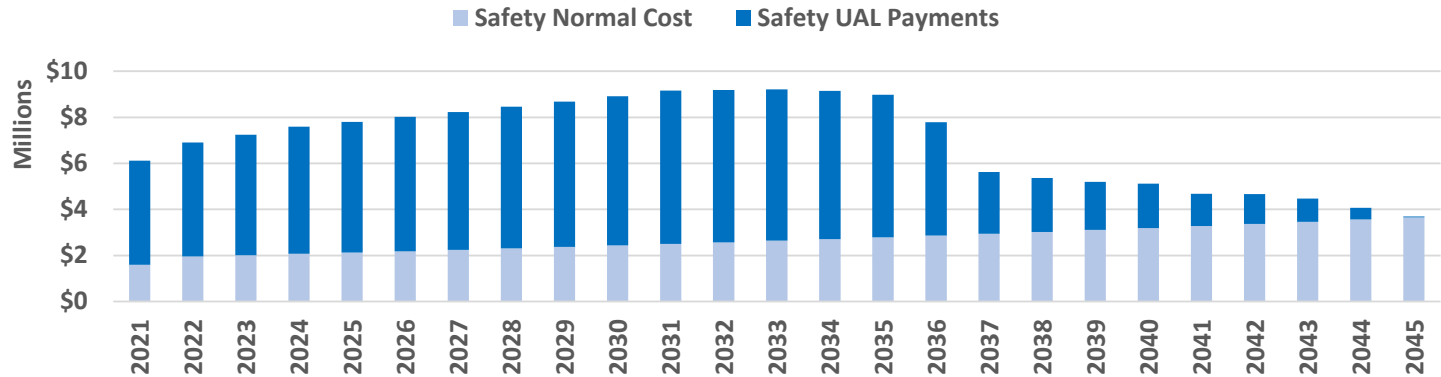
¹ Source: Most recent CalPERS actuarial valuation reports as of June 30, 2019, for fiscal year 2021-22.

Current Payment Amortization - Miscellaneous and Safety

Miscellaneous (1)(3)



Safety (2)(3)

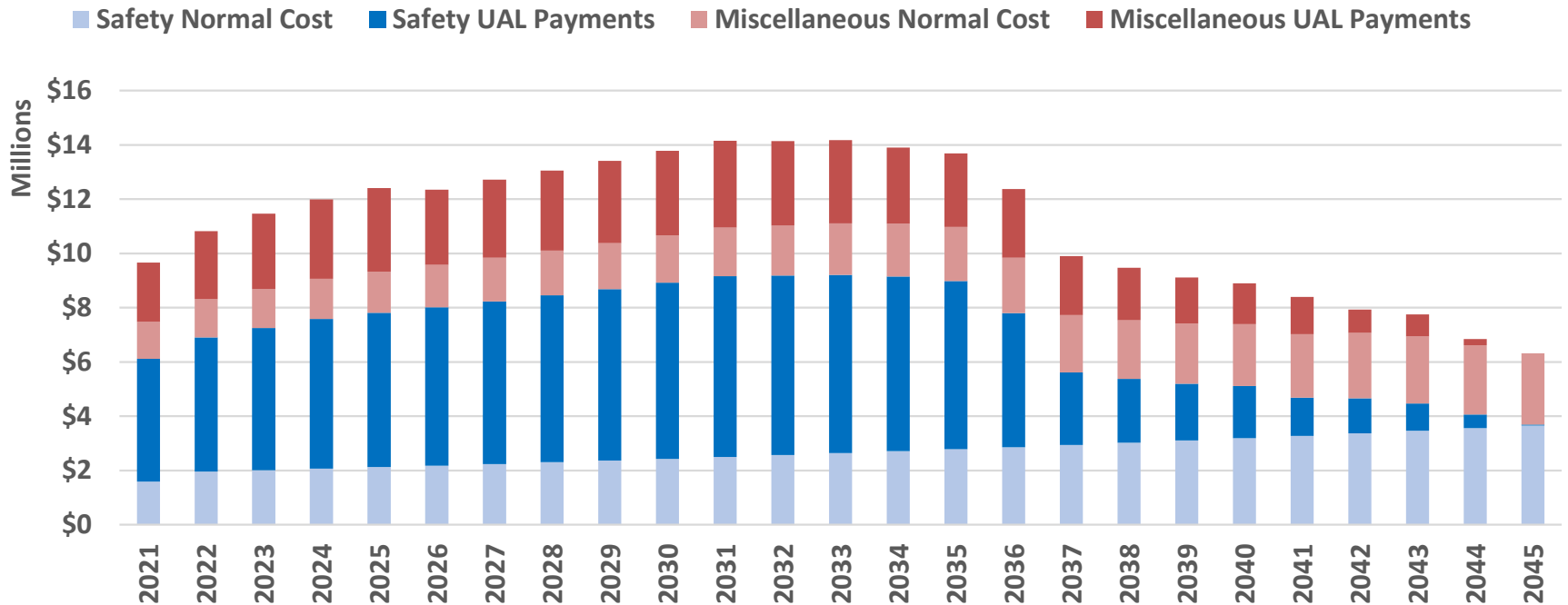


Source: Most recent CalPERS actuarial valuation reports as of June 30, 2019, for fiscal year 2021-22.

- (1) Miscellaneous normal cost projections are based on the 9.38% of the total Miscellaneous salary assuming an annual growth rate of 2.75%.
- (2) Safety normal cost projections are based on the 25.59% of the total Safety salary assuming an annual growth rate of 2.75%.
- (3) Normal Cost contributions will be made as part of the payroll reporting process. If there is a contractual cost sharing or other change, this amount will change.

Current Payment Amortization - Combined

Combined (1)



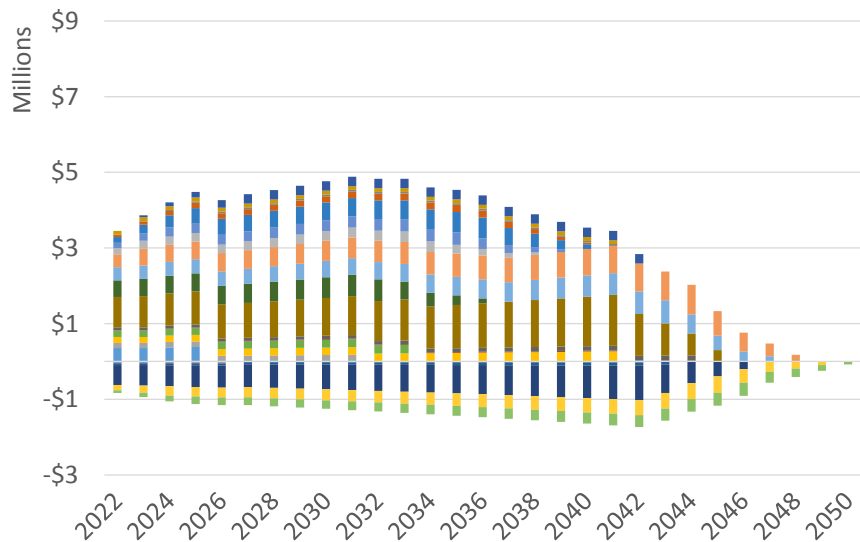
Source: Most recent CalPERS actuarial valuation reports as of June 30, 2019, for fiscal year 2021-22.

- (1) Miscellaneous normal cost projections are based on the 9.38% of the total Miscellaneous salary assuming an annual growth rate of 2.75%.
- (2) Safety normal cost projections are based on the 25.59% of the total Safety salary assuming an annual growth rate of 2.75%.
- (3) Normal Cost contributions will be made as part of the payroll reporting process. If there is a contractual cost sharing or other change, this amount will change.

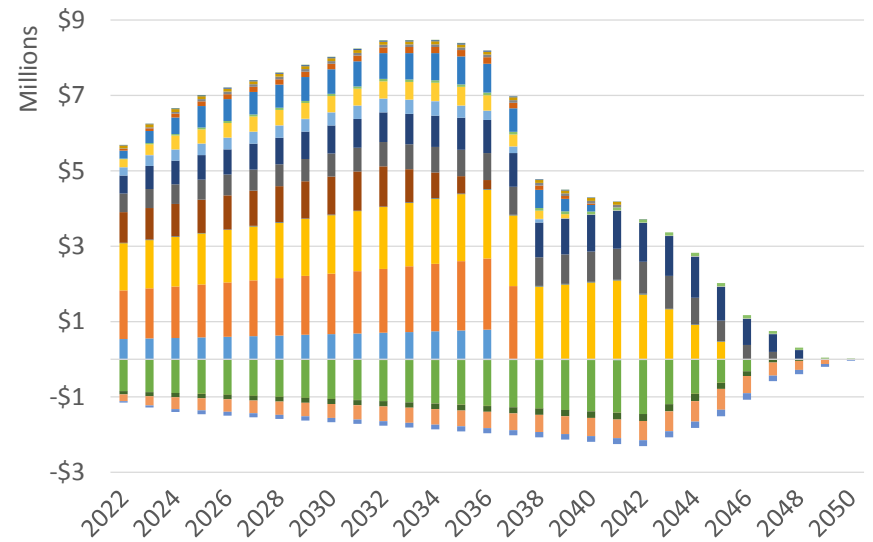
UAL - Miscellaneous Plan and Safety Plans Bases

- The UAL of the Miscellaneous and Safety Plans are comprised of individual amortization bases
 - ◆ Amortization bases can vary by term length, annual payments, and as a credit or a liability
 - ◆ CalPERS annually adjusts UAL and any changes in actual vs expected results in new bases
 - ◆ Bases that are negative are treated as a credit to the City's required contributions
- Miscellaneous and Safety have 71 Amortization Bases
 - ◆ Miscellaneous Plans: 22
 - ◆ Safety Plans: 49

**City of La Habra Miscellaneous Plan
UAL Payments by Amortization Bases**



**City of La Habra Safety Plans
UAL Payments by Amortization Bases**



UAL Potential Funding Options

- Accelerated Funding – Contribution of additional funds over the minimum required per year
 - ◆ Fresh Start - CalPERS creates a new, official UAL payment schedule of higher payments over a shorter term, e.g. 10, 15, 20 years
 - ◆ Advance Funding Plan - Discretionary payments made annually to CalPERS (e.g. \$1 million per year); typically adopted periodically as a multi-year plan
- Section 115 Trust
 - ◆ Similar to Advance Funding Plan but funds are set aside in a restricted trust
- Sell POBs to finance a portion of UAL

UAL Potential Funding Scenario

- Sell POBs to finance a portion of UAL
- Hypothetical scenario to target 80% to 85% funded ratios
 - ◆ CalPERS allows ability to payoff individual bases
 - ◆ Bases selection determined by individual UAL balance amount and amortization period combined with the goal of shortening the overall average life, POB interest expense, and risk profile
 - Shorter amortization periods will have a lower POB interest expense, but the shorter time period decreases the chance of realized savings
 - Longer amortization periods will have a higher POB interest expense, but the longer time period increases the chance of realized savings

Summary of POB Scenario Assumptions

Funded Ratios					
	Total Accrued Liability	UAL Balance	<i>Before POBs</i> Funded Ratios	Estimated UAL Balance Payoff	<i>After POBs</i> Funded Ratios
Miscellaneous Plan	\$124,762,116	\$31,867,433	74.5%	\$13,213,012	85.0%
Safety Plans	\$173,474,522	\$59,830,929	65.5%	\$34,230,283	85.2%
Total	\$298,236,638	\$91,698,362	69.3%	\$47,443,295	85.2%
	a	b	$c=(a-b)/a$	d	$= (a-b+d)/a$

POB Assumptions

- Current Taxable Interest Rates
 - ◆ S&P AA underlying rating
 - ◆ Optionally callable in 10 years
- No Reserve Fund
- No Extension of Final Maturity
- 85% Funded Ratio

Annual Payment Scenarios

- Proportional
- Level
- Combination

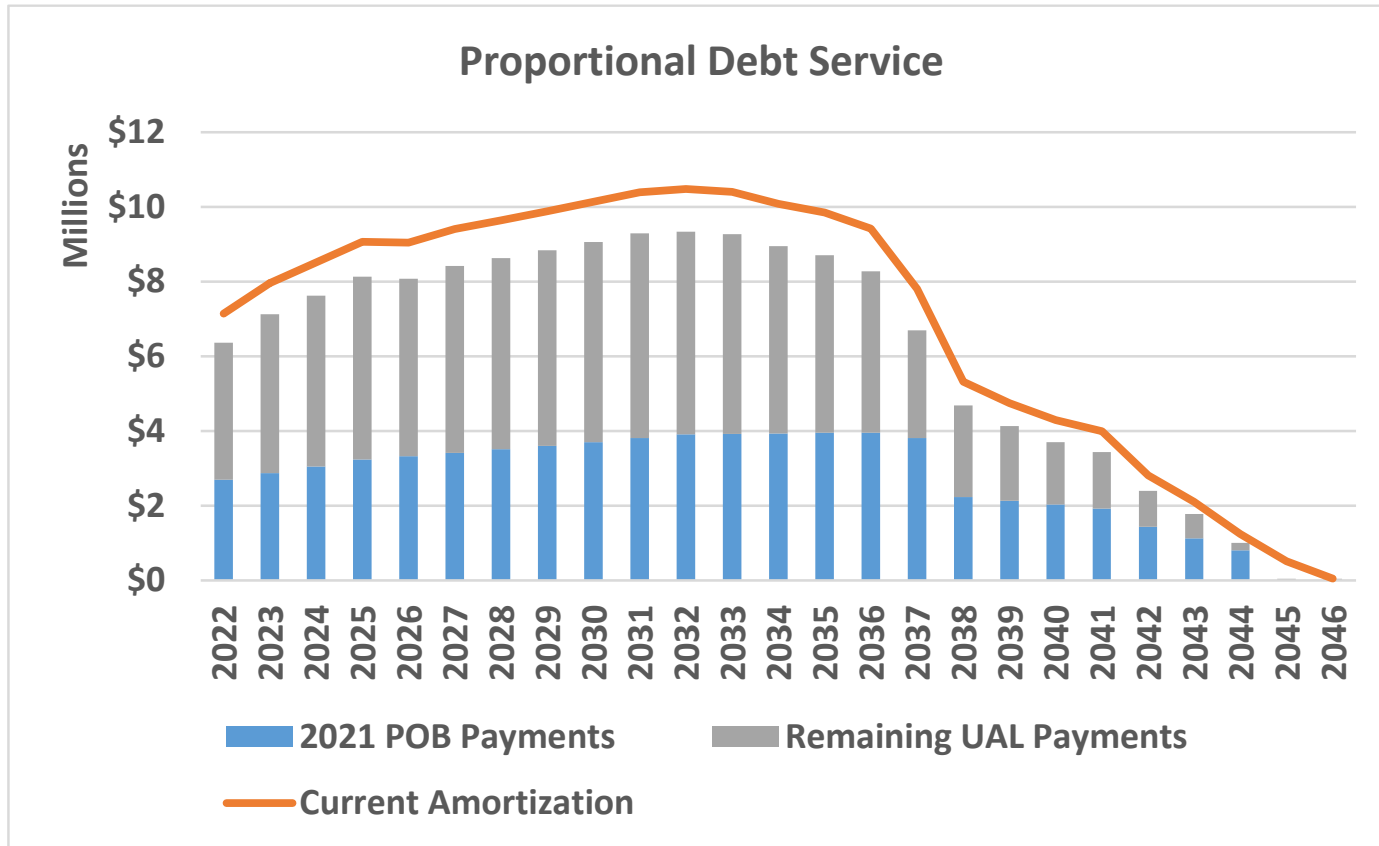
POB Savings Summary ¹

	Proportional (Years 1-23)	Level (Years 1-23)	Level (1-16) Proportional (17-23)
Sources & Uses			
Total Par Amount	\$47,985,000	\$47,985,000	\$47,985,000
UAL Balance Payoff	\$47,443,295	\$47,443,295	\$47,443,295
Issuance Expenses	\$541,705	\$541,705	\$541,705
Term			
Final Maturity Date	2044	2044	2044
Term Length	23 Years	23 Years	23 Years
Average Life	11 Years	13 Years	12 Years
Debt Service			
Total Debt Service	\$68,351,498	\$71,729,009	\$68,588,113
Maximum Annual Debt Service	\$3,955,590	\$3,121,099	\$3,349,713
Average Annual Debt Service	\$3,015,138	\$3,164,127	\$3,025,575
Savings			
All-in True Interest Cost	3.78%	3.89%	3.80%
Gross Savings	\$19,794,932	\$16,417,422	\$19,496,538
PV Savings	\$13,787,407	\$13,179,765	\$13,617,975

¹ Estimated. Actual savings numbers will depend on the final POB interest rates achieved and the CalPERS actual investment performance over the life of the POBs to final maturity. The CalPERS performance rate will fluctuate, and the City has no control over CalPERS' investment performance.

Proportional Savings Profile ¹

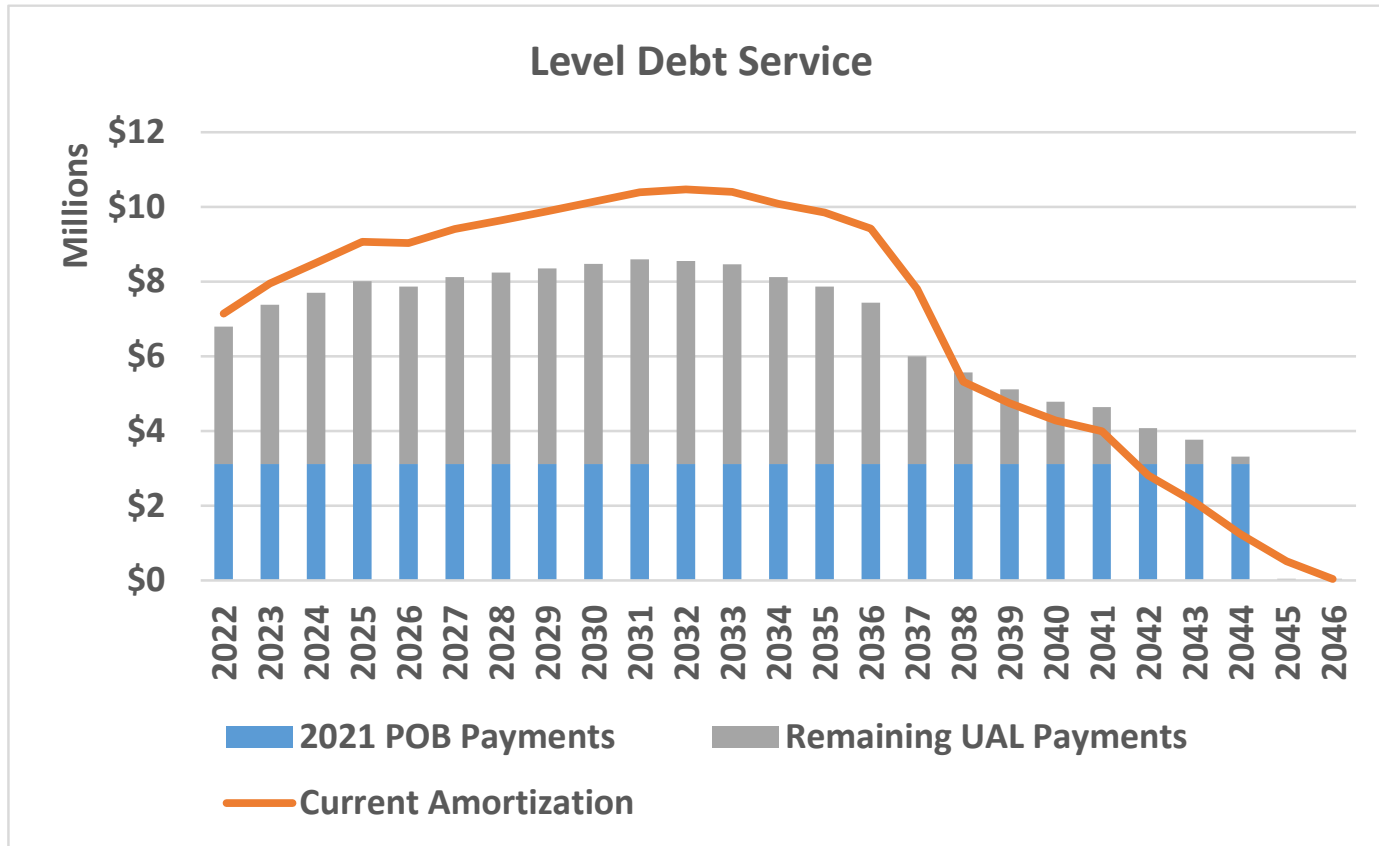
- POB Proportional Annual Debt Service
 - ◆ Years 1 -23



¹ Estimated. Actual savings numbers will depend on the final POB interest rates achieved and the CalPERS actual investment performance over the life of the POBs to final maturity. The CalPERS performance rate will fluctuate, and the City has no control over CalPERS' investment performance.

Level Savings Profile ¹

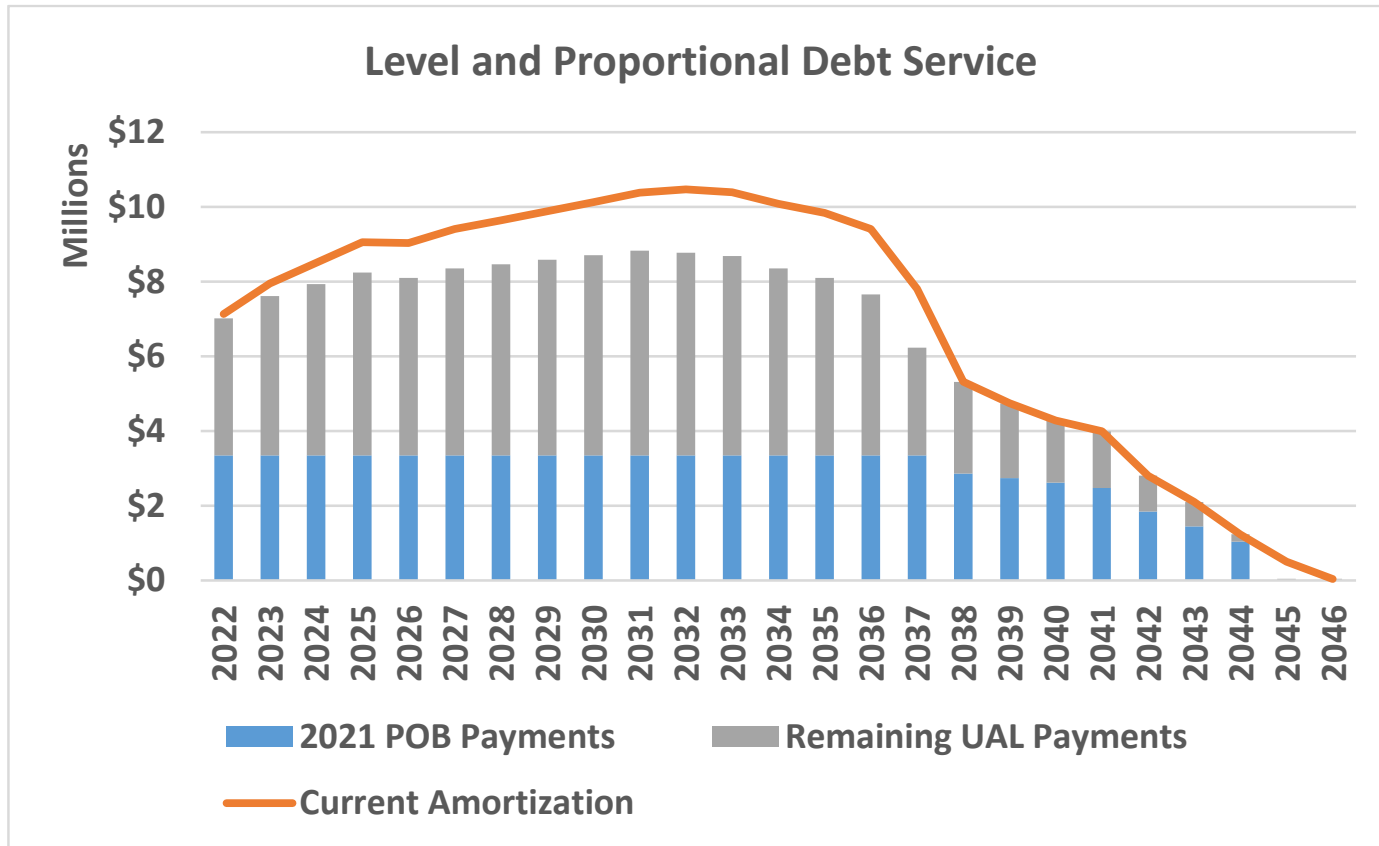
- POB Level Annual Debt Service
 - ◆ Years 1 -23



¹ Estimated. Actual savings numbers will depend on the final POB interest rates achieved and the CalPERS actual investment performance over the life of the POBs to final maturity. The CalPERS performance rate will fluctuate, and the City has no control over CalPERS' investment performance.

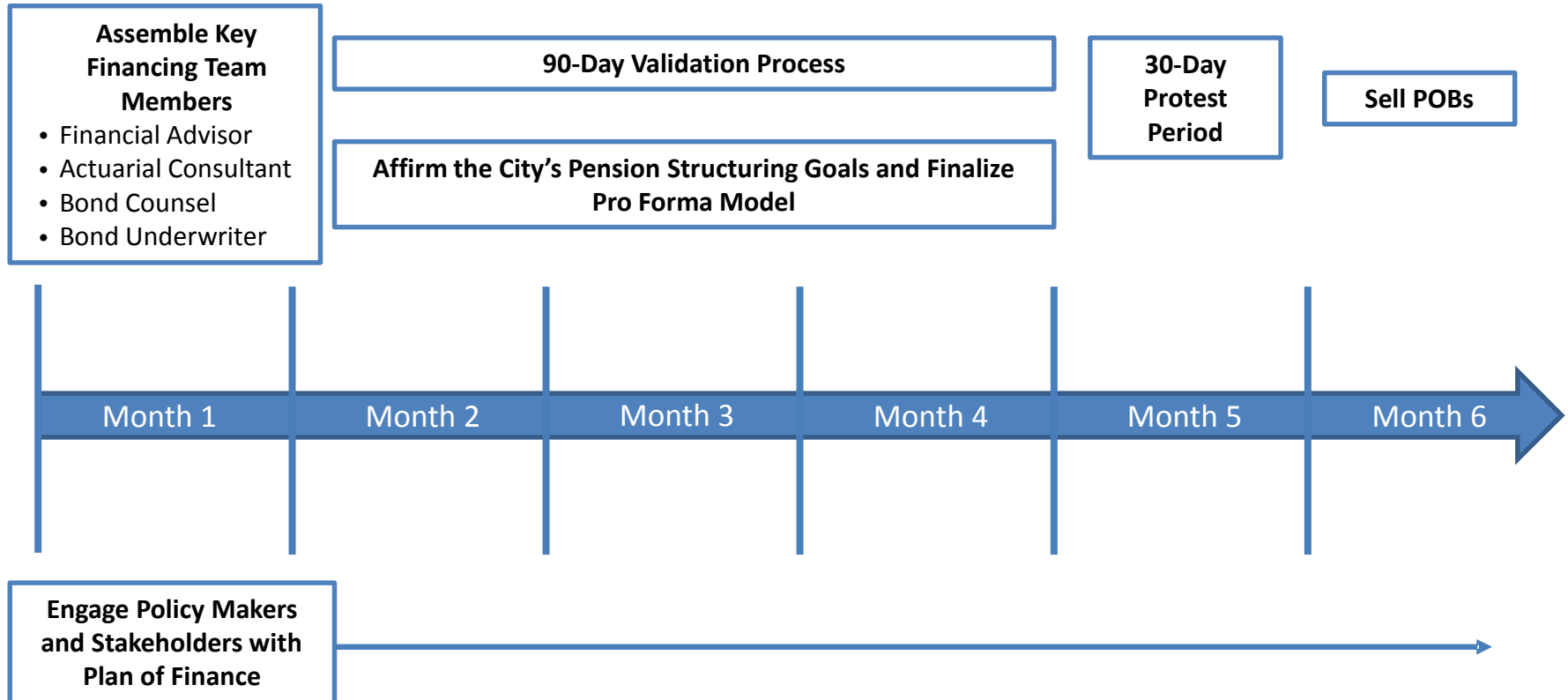
Level and Proportional Savings Profile ¹

- POB Level and Proportional Annual Debt Service
 - ◆ Level: Years 1 -16
 - ◆ Proportional: Years 17 - 23



¹ Estimated. Actual savings numbers will depend on the final POB interest rates achieved and the CalPERS actual investment performance over the life of the POBs to final maturity. The CalPERS performance rate will fluctuate, and the City has no control over CalPERS' investment performance.

POB Next Recommended Steps



Section III

Primer on Risks/Benefits of POBs



POB Costs and Savings

- To evaluate a potential POB, the City's actuarial consultant will measure the change in the City's future cash flows with and without a POB
 - ◆ "Debt Service" – The City will pay off POBs over time on a fixed schedule
 - ◆ POB funds will be paid directly to CalPERS
 - City's CalPERS unfunded liability will be reduced
 - City's future required contributions to CalPERS will (usually) be reduced.
 - Future required CalPERS contributions depend on actual future investment return
 - ◆ All calculations based on present value now, to account for time value of money

POB Costs and Savings

- Actual calculation of savings will depend on future years' CalPERS investment return
 - ◆ It will not be 7% every year, and usually not close to 7%.
 - ◆ The actuary runs 1,000 simulations modeling possible scenarios
- In most scenarios, City's cash flow with POB will be lower
 - ◆ CalPERS charges 7% interest on UAL; Debt service will be less than 7%
- In some scenarios the City's cash flow with POB will be higher, if:
 - ◆ CalPERS investment return is very bad
 - ◆ CalPERS investment return is very good

POB Costs and Savings

- The actuary will calculate how likely the City's cash flow is to be reduced
 - ◆ How much are the savings likely to be?
 - ◆ If cash flows increase, how much is the additional cost likely to be?
- The actuary will repeat this modeling for different POB amounts designed to pay off different percentages of the unfunded liability
 - ◆ Typically the success rate is different for each scenario

Selecting Size of POB

- The actuary's calculations will show, for different POB amounts:
 - ◆ How likely is it that future cash flows will be reduced compared to no POBs being issued
 - ◆ What the savings are likely to be
 - ◆ What the expected future CalPERS contributions/cash flows are likely to be
- The actuary modeling gives the City information needed to select a POB amount, considering
 - ◆ What level of risk the City is comfortable with
 - ◆ What level of reduction in future CalPERS required contributions (if any) is desired

What to Do With POB Savings

- If the City issues POBs, it has many options it can choose from, depending on its unique situation
 - ◆ Key considerations include, using savings to further reduce CalPERS UAL
 - Set aside some or all of the savings in a separate trust
 - Make an additional CalPERS contribution each year in the amount of some or all of the POB savings
 - ◆ Use savings to prefund retiree healthcare (OPEB) obligations
 - ◆ Use savings for other City budget priorities
 - ◆ Some combination of all these strategies

Section IV

Recommendations



Recommendations

- Receive and file the POB report and presentation
- Authorize staff to initiate a Court Validation process at a cost of approximately \$30,000
- Direct staff to proceed with the additional evaluation of potential Pension Obligation Bonds for City Council consideration once the Validation Process is complete

Other Considerations for POBs

- ✓ Hire an Actuarial Firm
- ✓ City Council Study Session
- Stakeholder Outreach
- Expect opposition