City of Palo Alto (ID # 6792)

Finance Committee Staff Report

Report Type: Action Items **Meeting Date: 4/5/2016**

Summary Title: Unfunded Pension Liability

Title: Staff Recommends the Finance Committee Review the Various Options to Address the Unfunded Pension Liability and Provide Direction on a Funding Plan

From: City Manager

Lead Department: Administrative Services

Recommendation

Staff recommends the Finance Committee review the various options to address the unfunded pension liability and provide direction on a funding plan.

Background

Staff presented a report to Council at its September 9, 2015 Study Session (CMR ID#6074), and John Bartel, the City's actuary, delivered a presentation regarding the City's pension plans and unfunded liability. After the discussion, the City Council referred the matter to the Finance Committee for further discussion and clarification of specific options to address the liability.

There are two overalls goal concerning the pension liability: 1) reducing the volatility of future pension rates, and 2) reducing the unfunded liability earlier than required by CalPERS.
On November 3, 2015 (CMR ID# 6240), Mr. Bartel presented funding options to the Finance Committee. He discussed several vehicles for addressing pension issues. The first was to pay an extra $1 million annually towards the unfunded expenses for safety and miscellaneous employee trusts at CalPERS and, while the impact is relatively small, it begins to address this serious issue. Additional funds could then be added in future years should fund surpluses emerge. In addition, the discussion focused on establishing a Section 115 Irrevocable Trust which would allow for City funds to accumulate and count towards offsetting the unfunded liability. There are at least two firms that provide Section 115 trusts and staff was directed to explore options.

The establishment of a Section 115 Trust would be used to fund gaps during economic downturns. For example, if the General Fund had a $3 million shortfall and it already had contributed $8 million to the Trust, Council could direct the use of $3 million of the $8 million to pay the annual pension obligation. Staff would recommend adding funding from the various funds in the organization based on the percentage of payroll and track the funding and drawdowns ensuring that each fund only contributes and pays based on their share of the unfunded liability.

Also discussed, was the option of issuing Pension Obligation Bonds (POBs) to pay down the unfunded pension liability. Staff researched this option and is including the Government Finance Officers Association (GFOA) best practices/ advisories (Attachment A) regarding the issuance of POBs and Other Postemployment Benefit (OPEB) Bonds (Attachment B). The GFOA advises against issuing such bonds. Below are some of the reasons:

1) The invested POB proceeds may fail to earn more than the interest rate owed over the term of the bonds.
2) POB and OPEB bonds are complex instruments that carry considerable risk.
3) Issuing taxable debt to fund pension and OPEB liabilities increases the jurisdiction's bonded debt burden and potentially uses debt capacity that could be used for other purposes.

On December 15, 2015 (CMR ID# 6428), Mr. Bartel continued the discussion of unfunded pension and OPEB liabilities with the committee. He described a recently adopted CalPERS Risk Mitigation Strategy whose goal was to reduce investment return risk over time and reduce the expected rate of return to 6.5% over a 20 year period. The reduction of the expected rate of return would only occur in years when investment returns was high. Mr. Bartel presented charts showing how the rate of return impacts the annual employer contribution showing poor and positive results.

Discussion

As part of the FY 2015 year-end financial approval process, staff recommended that the Finance Committee set aside $1.3 million from the General Fund surplus as seed funding towards the unfunded pension liability. The Finance Committee and Council approved the recommendation. The funds are residing in the General Fund Budget Stabilization Reserve (BSR) pending the review of options and the City's financial condition. Staff will return with specific funding recommendations for each fund and a recommended provider of the Section 115 trust at a future date.

In the future, Mr. Bartel will provide updated CalPERS pension calculations and continue the discussion of how to address funding of the unfunded pension liability.

Resource Impact

The $1.3 million for potentially funding unfunded pension liability resides in the General Fund Budget Stabilization Reserve. These funds, as well as corresponding portions from other Funds, can be considered as seed money for initiation of a Section 115 Trust.

Attachments:

- Attachment A: GFOA Best Practice/Advisory POB (PDF)
- Attachment B: GFOA Best Practice/Advisory OPEB (PDF)

Attachment A

Pension Obligation Bonds

Type: Advisory
Advisory:
GFOA Advisories identify specific policies and procedures necessary to minimize a governments exposure to potential loss in connection with its financial management activities. It is not to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Approved by GFOA's Executive Board: January 2015
Background:
Pension obligation bonds (POBs) are taxable bonds[1] that some state and local governments have issued as part of an overall strategy to fund the unfunded portion of their pension liabilities by creating debt. The use of POBs rests on the assumption that the bond proceeds, when invested with pension assets in higher-yielding asset classes, will be able to achieve a rate of return that is greater than the interest rate owed over the term of the bonds. However, POBs involve considerable investment risk, making this goal very speculative.[2] Failing to achieve the targeted rate of return burdens the issuer with both the debt service requirements of the taxable bonds and the unfunded pension liabilities that remain unmet because the investment portfolio did not perform as anticipated. In recent years, local jurisdictions across the country have faced increased financial stress as a result of their reliance on POBs, demonstrating the significant risks associated with these instruments for both small and large governments.

Recommendation:
The Government Finance Officers Association (GFOA) recommends that state and local governments do not issue POBs for the following reasons:

1. The invested POB proceeds might fail to earn more than the interest rate owed over the term of the bonds, leading to increased overall liabilities for the government.
2. POBs are complex instruments that carry considerable risk. POB structures may incorporate the use of guaranteed investment contracts, swaps, or derivatives, which must be intensively scrutinized as these embedded products can introduce counterparty risk, credit risk and interest rate risk.[3]
3. Issuing taxable debt to fund the pension liability increases the jurisdiction's bonded debt burden and potentially uses up debt capacity that could be used for other purposes. In addition, taxable debt is typically issued without call options or with "make-whole" calls, which can make it more difficult and costly to refund or restructure than traditional tax-exempt debt.
4. POBs are frequently structured in a manner that defers the principal payments or extends repayment over a period longer than the actuarial amortization period, thereby increasing the sponsor's overall costs.
5. Rating agencies may not view the proposed issuance of POBs as credit positive, particularly if the issuance is not part of a more comprehensive plan to address pension funding shortfalls.

Committee: Retirement and Benefits Administration
Notes:
1 The Tax Reform Act of 1986 eliminated the tax exemption for pension obligation bonds.

2 Alicia H. Munnell, Jean-Pierre Aubry, and Mark Cafarelli, "An Update on Pension Obligation Bonds," Center for Retirement Research at Boston College, July 2014.

3 See GFOA Advisory – *Using Debt-Related Derivatives and Developing a Derivatives Policy (2015)*

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Attachment B

Other Postemployment Benefits (OPEB) Bonds

Type: Advisory

Approved by GFOA's Executive Board: January 2016

Background:

GASB Statement No. 75, *Accounting and Financial Reporting for Employers for Postemployment Benefits Other than Pensions*, requires public-sector employers to display, in the government-wide statement of net assets, the full amount of their net OPEB liability (NOL) for other postemployment benefits earned by employees for services rendered to date.[1] In addition, employers that subsequently fail to fully fund their actuarially determined contribution (ADC) each year will also be required to report the cumulative effect of underfunding the ADC as required supplementary information. Nothing in GASB Statement No. 75 requires employers to advance fund their OPEB obligations. The decision to advance fund OPEB should reflect a given jurisdiction's careful analysis of its own unique financial situation.

Some employers have considered issuing debt to fund their NOL for OPEB, as has sometimes been done in connection with pension obligations. In either case, the objective is to invest the proceeds in appropriate qualified investments at a return substantially higher than the interest rate of the debt. GFOA has adopted an advisory that addresses the issuance of debt in connection with pension obligations.[2] While the underlying concept is the same, several crucial additional factors must also be considered for OPEB bonds.

Recommendation:

GFOA recommends that state and local governments do not issue OPEB bonds, for the following reasons:

1. The actuarial liability for OPEB is inherently and significantly more volatile than the actuarial liability for pension benefits, for several important reasons. First, health-care costs and utilization are less predictable than life expectancy. Second, unlike pension benefits, health-care benefits are not guaranteed by state law in many jurisdictions, and employers may choose to reduce, cap, or eliminate these benefits.[3] Third, state or federal health-care initiatives might also significantly change the way health-care benefits are provided in the future. Furthermore, health-care cost trends are generally more volatile and difficult to project than inflation rates for pension costs because the former must take into account ongoing changes in medical technology and societal expectations.
2. OPEB bonds may be complex instruments that carry considerable risk. OPEB bond structures must be intensively scrutinized, as debt structures may incorporate the use of guaranteed investment contracts, swaps, or derivatives, which can introduce counterpary risk, credit risk, and interest rate risk.
3. Issuing taxable debt to fund the OPEB liability increases the jurisdiction's bonded debt burden and potentially uses up debt capacity that could be used for other purposes. In addition, taxable debt is typically issued without call options or with "make-whole" calls, which can make it more difficult and costly to refund or restructure than traditional tax-exempt debt.
4. Rating agencies and similar authorities have not provided definitive guidance as to what constitutes a safe and reasonable funded ratio for OPEB.
5. Ratings agencies may not view the proposed issuance of OPEB bonds as credit positive, particularly if the issuance is not part of a more comprehensive plan to address OPEB funding shortfalls.
6. The potential volatility in actuarial estimates could lead to over-funding, especially in cases where the jurisdiction fully funds the NOL. Such overfunding could raise potentially troublesome budgetary or policy issues.[4]
7. The invested OPEB bond proceeds might fail to earn more than the interest rate owed over the term of the bonds, leading to increased overall liabilities for the government.

Committee: Retirement and Benefits Administration

Notes:

1. Only employers participating in defined benefit plans will display a net pension liability.
2. Originally issued in 1997 and subsequently revised in 2015 to reflect the significant adverse impact of pension obligation bonds on state and local governments.
3. See the "Sustainable Funding Practices for Defined Benefit Pensions and Other Post-Employment Benefits" best practice.
4. See the "Ensuring Other Postemployment Benefits (OPEB) Sustainability" best practice.

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