Agenda Report

Fullerton City Council

MEETING DATE: **JANUARY 18, 2022**

TO: **CITY COUNCIL / SUCCESSOR AGENCY**

FROM: **JEFF COLLIER, ACTING CITY MANAGER**

PREPARED BY: **ELLIS CHANG, DIRECTOR OF ADMINISTRATIVE SERVICES**

URBAN FUTURES, INC., CITY CONSULTANT

SUBJECT: **PENSION OBLIGATION BONDS - OVERVIEW**

SUMMARY

A macro overview of the City's CalPERS Pension Liability and a brief presentation of Pension Obligation Bonds (POBs) as a potential strategy to address the outstanding pension Unfunded Accrued Liability (UAL).

RECOMMENDATION

Recommendation:

1. Receive and file.
2. Provide direction to:
   - Retain Urban Futures, Inc. to perform in-depth analysis for an estimated $15,000 cost.

     and /or

   - Retain validation counsel at an estimated $40,000 cost and initiate validation proceedings.

BUDGET POLICY PRIORITY STATEMENT

This item matches the following Budget Policy Priority Statement:

- Fiscal and Organizational Stability.

FISCAL IMPACT

No fiscal impact to receive and file this agenda report and study session materials. However, should City Council direct staff to proceed with in-depth analysis and/or validation proceedings, the estimated cost to the General Fund totals $55,000. Staff will submit an appropriation request at a subsequent City Council meeting to retain Urban Futures, Inc. to conduct an in-depth analysis and to retain validation counsel and initiate validation proceedings.

DISCUSSION

The study session presentation provides a high-level overview of the City's CalPERS Unfunded Accrued Liability (UAL) which equaled $282,857,335 as of the June 30, 2020 valuation report.

The presentation will also provide an initial examination of Pension Obligation Bonds as a potential strategy to address the UAL.

While not without risk, current market conditions make pension obligation bonds a potentially favorable funding option to address the City's pension liabilities. For example, if the City issued POBs to cover the full amount of the unfunded pension liability at the current low interest rates and apply a 22-year hybrid structure, the City could potentially achieve annual budgetary savings of ~$3.7 million over each of the first 15 years of debt service payments. This would provide the City with the ability to direct some or all these annual savings to reinstate City services or other projects and programs designated by City Council.

Issuing POBs comes with associated risks as described further in this document. The primary risk pertains to market timing as the City will not know the net financial impact from a POB until it has paid off the bonds. Market timing risk is the inability to assess whether the impact of making a significant one-time payment provided the better course of action rather than simply paying down the Unfunded Accrued Liability (UAL) over time per CalPERS required payment schedule at CalPERS established interest rates.

A number of agencies throughout California have issued POBs, the vast majority of which have issued within the last two years, taking advantage of the low interest rate environment. Attachment 1 presents a list of agencies which have issued POBs within the past several years and highlights the agencies in Orange County that have issued POBs as a pension strategy.

Should the City have interest in moving forward, City Council should direct staff to retain Urban Futures, Inc. to perform an in-depth analysis and support outreach and education efforts. The cost for this service totals an estimated $15,000. Should City Council have interested in simultaneously positioning the City to take advantage of market conditions, City Council may also direct staff to select and retain validation counsel to initiate formal legal court validation proceedings. Retaining validation counsel is a necessary part of the issuance of POBs. Fees typically range between $25,000 to $35,000, plus court filing fees ($3,000 to $5,000). Fees can be higher if the validation is challenged.

In generic form, validation proceedings would include the following:

- The City must adopt a resolution that authorizes the City to pursue the issuance of POBs to refund its CalPERS UAL and the commencement of judicial validation proceedings related to the issuance of such POBs. This requires a filing with the Orange County Superior Court seeking authorization to issue POBs.
- City initiation of an eight-step validation process that can take approximately 90 to 120 days.
- If the City is successful in validation proceedings, the City would then have the option to further explore the issuance of debt to 'refinance' all or a portion of the City's CalPERS Unfunded Accrued Liability. It is important to note that the City, at this stage, has the ability to continue or not to continue with issuance of POBs.
    - If the City decides to move forward and issue POBs, it may retain validation counsel to act as bond counsel and the City may retain its municipal advisory firm, Urban Futures, Inc., as part of the POB issuance financing team. At this stage, Urban Futures, Inc. would assist the City to assemble the remaining financing team members to develop a recommended debt structure for the POB issuance pursuant to City Council direction. The City would pay the POB financing team separately on a contingent basis for this scope of services out of POB proceeds.

POB Validation Proceedings

If a public entity chooses to move forward to issue POBs, it will need to initiate Validation Proceedings. Validation Proceedings are the process by which a court "validates" pension obligation bonds as a refunding of an existing debt. This is required for POBs because the California Constitution does not consider UAL payments bonded debt by default. Without validation, refunding a City's UAL with POBs would be considered a new debt obligation, thus requiring voter approval. Once a POB issue has completed validation, however, the UAL payments to CalPERS are treated as obligations by law and therefore can be refunded by POBs under the local agency refunding law.

In order to obtain authorization to issue POBs, the City must file a validation action with the Orange County Superior Court. Unless challenged, the judicial validation proceedings constitute an administrative matter managed by Validation Counsel.

In order to file a validation action, the City must first adopt a resolution authorizing the City to issue POBs to refund its CalPERS UAL and authorizing judicial validation proceedings related the issuance of such POBs.

Validation Procedures

The validation proceedings require an eight-step sequential process, which can take 90 to 120 days in Orange County. The following outlines the process and estimated timeline:

1. City Council passes a resolution authorizing its intention to sell pension obligation bonds**
2. File Validation Action with Orange County Superior Court

3. Receive Order for Publication of Summons from the Court – one to two weeks
4. Publication in the Orange County Register for 21 consecutive days
5. Waiting period to file petition – minimum of ten days, typically two to three weeks for Orange County
6. Clerk enters hearing for a default judgement, schedules a hearing in 15 days
7. Hearing for default judgement
8. 30-day Appeal Period.

**Legal documents must be in substantially final form and the City must determine a not-to-exceed par value. Bonds can be sold after the 30-day Appeal Period has ended and City Council approves the Official Statement for the Bonds and the final structure. The above-described schedule is subject to potential delays due to the pandemic's effects on the Court system.

Should the City Council decide to move forward with the judicial validation action, a subsequent City Council action is required to approve a Preliminary Official Statement for the Bonds and to provide City Staff and the financing team direction on the desired structure (such as the 22-year hybrid structure example provided above) of the POB refunding. The ultimate bond issuance structure will be developed based on City Council's direction as to a number of factors such as the amount of debt to be issued, whether level or hybrid debt service payments are desired, the final term of the bonds, etc.

The judicial proceedings constitute an administrative matter, usually handled by a bond counsel firm acting as validation counsel. Fees typically range between $25,000 to $35,000, plus court filing fees (additional $3,000 to $5,000). These fees are non-contingent and payable regardless of bond issuance. If the validation is challenged, and the City elects to defend the validation, the fixed fee cost would therefore convert to an hourly basis ranging from $500 to $750 per hour based on actual costs to complete the validation.

To date, staff knows of a few validation challenges and zero defended challenges. Most challenges have resulted in potential POB issuers restructuring the transaction to a Lease structure requiring collateral or have abandoned the process all together.

Required Legal Documents - Before filing the validation action, City Council must first adopt a resolution authorizing the City to issue Pension Obligation Bonds (POBs) to refund its CalPERS Unfunded Accrued Liability (UAL) and authorizing judicial validation proceedings related the issuance of such POBs. The authorizing resolution must also establish a not-to-exceed par value and maximum interest rate. As part of its approval, City Council will approve two key legal documents, in substantially final form: Trust Indenture and Bond Purchase Agreement. Staff will draft the Preliminary Official Statement (POS) and City Council will approve after validation approval.

The POS is the offering document with respect to the POBs and, if the City will sell POBs by public offering, the POS must contain all material information to enable investors to determine whether to purchase POBs. The City cannot issue bonds without City Council approving a POS at a public meeting.

Government Finance Officers Association (GFOA) POB Risk Advisory

GFOA recommends state and local governments use caution when issuing POBs and outlines their potential risks:

GOFA POB Advisory	
1.	POBs are complex instruments that carry considerable risk.
2.	Invested POB proceeds may fail to earn more than the interest rate owed over the term of the bonds, which could lead to an increase in pension liabilities.
3.	Issuing POBs increases debt burden / reduces debt capacity that could be used for other purposes.
4.	POBs have “make whole calls”, which do not provide opportunity to refund bonds in the future.
5.	POBs should <u>not</u> be structured in a manner that defers the principal payments or extends repayment over a longer period.
6.	Rating agencies may not view POBs as a rating positive, particularly, if not part of a comprehensive plan to address pension shortfalls.

While the City could mitigate some of these risks by establishing the appropriate structure of the bonds, it cannot reduce the primary market timing risk. Market timing risk is the inability to assess whether the impact of making a significant onetime payment was the better course of action rather than simply paying down the Unfunded Accrued Liability (UAL) over time per CalPERS required payment schedule at CalPERS established interest rates.

The City’s consultant, Urban Futures, Inc., has identified measures other issuing agencies have taken to mitigate risks outlined by the GFOA. The following provides mitigating measures in italics.

GOFA POB Advisory & *Mitigating Measures*	
1.	POBs are complex instruments that carry considerable risk.
	POBs should only be issued as plain vanilla fixed-rate bonds. The structure assumed in the analysis does not include GIC’s, swaps or derivatives. Fixed rate bonds will enable the City to have future budget certainty by locking in a debt service payment schedule at closing. In addition, the current historically low interest rate environment makes it advantageous for issuers to sell long-term fixed rate bonds.
2.	Invested POB proceeds may fail to earn more than the interest rate owed over the term of the bonds, which could lead to an increase in pension liabilities.
	The financial impact of POBs is dependent upon two variables: 1) Borrowing rate on the Bonds and 2) CalPERS investment performance. *POBs provide savings by refinancing UAL payments at a taxable fixed rate, as opposed to blended rate for a portfolio of assets (50% equities / 22% fixed income*

	/ 12% real estate / 8% private equity / 6% inflation assets / 3% liquidity). Invested POBs may lose value if the market declines soon after issuance. *Additionally, if CalPERS underperforms its target rate, the City's UAL will increase, regardless if bonds are issued. However, the issuance of bonds may reduce the annual financial impact of losses from investment returns or policy changes made by the CalPERS Board. It is recommended that interest rate stress testing be conducted as part of the process to evaluate and consider risks associated with POBs.*
3.	Issuing POBs increases debt burden / reduces debt capacity that could be used for other purposes.
	An agency's CalPERS UAL liability is considered "debt" by the courts in California and GASB 68. Moreover, UAL payments are fixed dollar payments, like a traditional loan, financed at a discount rate of 7.0%. POBs "refinance" the CalPERS liability at a lower rate. In the POB analysis presented, the true interest cost is 3.08%, which is well below the current discount rate of 7.0%.
4.	POBs have "make whole calls", which do not provide opportunity to refund bonds in the future.
	POBs are now structured with standard optional redemption features like traditional tax-exempt bonds. The estimated savings provided in this memo are based on a standard 10-year optional redemption feature. A 10-year optional redemption feature means the City will have flexibility to prepay the Bonds after 10 years at no penalty. This ensures flexibility should the City wish to refinance at lower interest rates in the future.
5.	POBs should <u>not</u> be structured in a manner that defers the principal payments or extends repayment over a longer period.
	POBs should not include normal costs (except for annual pre-pay amount), nor be structured with an extended repayment schedule - final maturity. The POB analysis above is limited to the City's UAL only, and assumes a final maturity in 2044, which is the same as the final term of the City's current UAL bases.
6.	Rating agencies may not view POBs as a rating positive, particularly, if not part of a comprehensive plan to address pension shortfalls.
	POBs should be one part of a comprehensive pension management strategy that further enhances the City's strong credit fundamentals. In its March 2021 rating report for the City, Standard & Poor's identified the City's large pension obligation as a credit weakness. A comprehensive plan, which includes the issuance of POBs, could be implemented to address the concern identified by Standard & Poor's. It is recommended that a thorough education process regarding the UAL be completed concurrently with the development of a pension management strategy.

Next Steps

Should City Council wish to further examine POBs as strategy, City Council should provide direction to appropriate funds and retain Urban Futures, Inc. to conduct an in-depth analysis and with respect to selecting validation counsel to proceed with required legal court validation proceedings.

Staff will make study session presentation materials available as supplemental materials.

Attachments:

- Attachment 1 – CA Pension Obligation Bonds: 2017-2021