KENSINGTON POLICE PROTECTION AND COMMUNITY SERVICES DISTRICT

BOARD OF DIRECTORS MEETING
MAY 14, 2020
ITEM 2

Receive Presentation by Kosmont Transactions Services Regarding Use of Pension Obligation Bonds to Fund the Current Public Employees Retirement System (CalPERS) Unfunded Liability and Provide Direction to Staff as Appropriate.

SUMMARY OF RECOMMENDATION:

Staff recommends that the Board of Directors receive a presentation by Kosmont Transactions Services regarding use of pension obligation bonds (POBs) to fund KPPCSD's current CalPERS unfunded liability and provide policy direction to staff.

BACKGROUND

Description of Pension Obligation Bonds

As part of the retirement benefit that KPPCSD offers its public safety employees, the District pays an amount to CalPERS which consists of two components: the normal cost and a scheduled payment toward any unfunded accrued liability (UAL). The normal cost is the total amount that a CalPERS actuary has determined should be charged to the agency and its employees on an annual basis, which, combined with investment earnings, is theoretically designed to fully fund all future pension obligations.

Each year, a CalPERS actuary determines the Actuarial Accrued Liability (AAL) for all member agencies. The AAL is the projection of the total amount that CalPERS should have in a member agency's account to cover promised benefits over time. The calculation takes into consideration investment earnings of funds on hand, future pension obligations, and future annual billings to the member agency. If the AAL for any member exceeds the member agency's "account," then the agency has an unfunded accrued liability (UAL) that constitutes a debt. CalPERS requires all members to make annual payments that will amortize the debt over a period of time.

As of June 30, 2020, KPPCSD's UAL is projected to be approximately $4.4 million, and CalPERS will require that it pay off this debt over an assumed period of 26 years. The interest rate charged on the debt is equal to the CalPERS assumed rate of earnings on investments, and it is this rate that CalPERS uses to determine the debt amortization schedule. For fiscal year 2019-20, the interest rate charged is 7.25%; for FY2020-21, it will be reduced to 7%. In sum, KPPCSD has "borrowed" from CalPERS a current amount of $4.4 (UAL) which is currently being paid back to CalPERS, amortized at an interest rate of 7% over a period of 26 years.

The underlying premise in using pension obligation bonds (POBs) is that, if an agency such as KPPCSD can reduce the interest rate that is currently charged to amortize its UAL debt (7%), then it will achieve cost savings. The amount of the savings is dependent on the difference between the current interest rate being charged by CalPERS and the new interest rate to be paid through the POBs. Through the use of pension obligation bonds, the current UAL debt to CalPERS is extinguished, and the debt transfers from CalPERS to bond holders.

It should be noted that the UAL is only extinguished for a point in time, and that the District will still need to make its normal cost contributions on an ongoing basis. If, for whatever reason, such as CalPERS not meeting its investment objectives or other changes in actuarial calculations, CalPERS does not collect enough from the District through normal cost contributions, the District could accrue a UAL in future years.

Proposed Pension Obligation Bonds for KPPCSD

Kosmont Transactions Services contacted the KPPCSD interim general manager to present an opportunity to use POBs to refinance the District's $4.4 million CalPERS UAL. The proposal involves a private placement of the bonds with Capital One Public Funding. The particulars of the proposed issue, in the context of a comparison with CalPERS funding of the UAL (status quo), is as follows:

	Pension Obligation Bonds	**CalPERS UAL Financing**
Principal	$4.5 million (approximate including costs of issuance)	$4.4 million
Term	20 years	26 years
Interest Rate	3.85%	7% current amortization rate
Debt service schedule	Level debt service mounting to $6.5 million over the life of the bonds	Variable debt service amounting to $8.3 million over the amortization period
Total interest paid	Approximately $2.0 million over the life of the bonds	Approximately $3.9 million over the amortization period
Costs of issuance	$120,000 (approximate, included in principal amount)	Not applicable

In sum, the use of pension obligations with the terms described above yields $1.8 million in gross savings, $1.2 million in net present value savings, or net present value savings of 26.42%.

The finance team members for the above-described transaction are:

- Kosmont Transactions Services – Independent registered municipal advisor (fiduciary);
- Nixon Peabody – District bond counsel
- Brandis Tallman – Placement agent

Finance Committee Review

At its meeting of May 7, 2020, the KPPCSD Finance Committee received a presentation from the POB finance team and had a productive discussion regarding their potential advantages and risks for use by KPPCSD. Following this discussion, the Committee voted to send the issue to the full Board of Directors without a recommendation.

Much of the Finance Committee's discussion related to the position by the Government Finance Officers Association that recommends against municipalities using POBs. The risk reasons underlying the GFOA position that are listed on their website, and their applicability to the proposed transaction, are provided with staff analysis below (GFOA position in *italics*).

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.*

    Analysis: This risk is not applicable to the current proposed POB issue. A common structure of POBs used in the past by other agencies was to invest bond proceeds in a separate interest bearing escrow account and use earnings from that account to pay CalPERS obligations. The reasoning was that earnings from that escrow would yield higher returns than those earned by CalPERS investments, which would effectively lower the cost of funding the pension for that agency.

    In the current proposed structure, there is no separate investment fund. All of the bond proceeds net of costs of issuance are provided to CalPERS for the benefit of reducing KPPCSD's UAL to zero, effectively lowering the interest charged by CalPERS from 7% to 3.85%. There is still a risk that CalPERS will not achieve its targeted investment rate and that a new UAL will begin to accumulate; however, that risk exists with or without the use of POBs.

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*.

    Analysis: This risk is not applicable to the current proposed POB issue. The current proposal is a simple, 20-year, fixed-rate, fully amortizing bond issue. Bond proceeds are used only to refinance existing UAL debt and pay issuance costs. The structure does not incorporate guaranteed investment contracts, swaps, or derivatives that might introduce counterparty risk, credit risk and interest rate risk.

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.*

    Analysis: While the current KPPCSD debt to CalPERS is not "traditional" debt used for infrastructure financing, it is, in fact, a current debt that currently appears in the footnotes to the financial statements. A sophisticated reading of the financial statements would see the District's UAL as comparable to any debt obligation of the agency. To the extent that balance sheet debt will increase by the amount of the POBs, it will also eliminate this UAL footnote.

    A common structure of POBs used in the past by other agencies was to not include call options where debt can be refunded or restructured. The current POB proposal has a par call option at 10 years, which will allow for refunding or restructuring this debt if financial conditions make it favorable to do so.

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.*

   Analysis: The proposed POBs do not defer principal payments nor do they extend the repayment period for the debt. In fact, the proposed POBs shorten the repayment period for the UAL debt by six years, from 26 years to 20 years. In addition, as described above, KPPCSD's overall costs are reduced by a gross amount of $1.8 million, with $1.2 million in net present value savings, or net present value savings of 26.42%.

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.*

   Analysis: The proposed POBs involve a private placement based on KPPCSD's credit. Thus, a conclusion regarding how the transaction is viewed by rating agencies is speculative. Based on the above analysis, it is difficult to defend the assertion that KPPCSD's refinancing CalPERS debt to achieve substantial savings with level debt service and a shorter amortization period could be viewed as a credit negative.

   In addition, the neighboring City of Larkspur recently completed a pension obligation bond issue and received a credit rating of AAA for that issuance. This was one level higher than the rating on their lease revenue bonds.

   As a policy option, separate from the consideration to utilize POBs, debt service savings from POBs can be used to address other post-retirement obligations of KPPCSD.

In an email from a member of GFOA staff to a member of the District's Finance Committee, there was a strong recommendation that KPPCSD retain a registered municipal advisor to assist in the proposed POB transaction. With respect to this underlying concern, it should be noted that Kosmont Transactions Services is acting as the Independent Registered Municipal Advisor ("IRMA"), as such term is defined by the Securities and Exchange Commission ("SEC") and Municipal Securities Rulemaking Board ("MSRB"), and is acting as fiduciary with respect to this transaction.

Finally, the Finance Committee speculated on why more agencies were not using POBs to refinance their UAL debt to CalPERS. There are several reasons why such an option is available to KPPCSD as part of a relatively small group of agencies:

- Because KPPCSD is a special district, the transaction is simplified and can be accomplished in a short period of time. This is due to the fact that, unlike cities and counties, there is no requirement for a validation proceeding that could take up to six months. The lack of the need for a validation proceeding makes it more likely to be able to do a private placement transaction with an interest rate lock.

- KPPCSD has strong credit factors, including a stable revenue base, that make it a candidate for a private placement – more so than other local governmental agencies.

- KPPCSD has a relatively high UAL for a special district; it is primarily a police services agency, with a PERS retirement benefit for police personnel. It should be noted that most of the other special districts that have recently issued POBs are also strongly weighted as public safety service districts, with many of them being fire protection districts with high relative UALs.

RECOMMENDATION

Due to the substantial cost savings to be achieved by refinancing the UAL debt to CalPERS, and with the understanding that the proposed POB structure does not have the risks identified in the generic (i.e., not transaction specific) GFOA analysis of POBs, staff recommends that the KPPCSD Board of Directors:

- Authorize the use of POBs as described in the report, and as presented by Kosmont Transactions Services;
- Direct that documents be prepared allowing for final approval of the transaction by the Board prior to required June 18 closing date.

ATTACHMENT

Presentation by Kosmont Transactions Services