BOARD OF DIRECTORS MEETING
June 11, 2020
ITEM 4

Authorization to Use Pension Obligation Bonds to Fund the Current Public Employees Retirement System (CalPERS) Unfunded Liability by Adopting Resolutions (1) Establishing a Debt Issuance Policy and (2) Authorizing the Issuance and Sale of the Bond.

SUMMARY OF RECOMMENDATION:

Discuss the use of pension obligation bonds to fund the current Public Employees Retirement System (PERS) unfunded liability and consider approval of the following:

- Resolution Establishing a Debt Issuance Policy for Future Obligations;
- Resolution Authorizing the Issuance and Sale of a Bond in the Principal Amount Not to Exceed $4,544,000 to Refund Certain Pension Obligations of the District, Approving the Form and Authorizing the Execution of a Commitment Letter and Authorizing Actions Related Thereto.

BACKGROUND

At its meeting of May 14, 2020, the KPPCSD Board of Directors received a presentation by a financial consulting team led by Kosmont Transactions Services, acting as the Independent Registered Municipal Advisor and fiduciary to the District, regarding the possible use of pension obligation bonds to fund the District's current Public Employees Retirement System (PERS) unfunded liability.

Following this presentation, the KPPCSD Board of Directors voted to direct that all documents be prepared allowing for final approval of the transaction by the Board prior to required June 18 closing date. The resolutions that are required for final approval are described below and are attached to this agenda report. Board adoption of both resolutions are necessary to complete the transaction.

<u>Resolution Establishing a Debt Issuance Policy:</u>

The State of California requires local agencies within the State, including special districts such as KPPCSD, to establish and implement a formal policy governing the methods by which the District issues debt obligations and the internal controls over the issuance of the Debt. The main objectives of the Debt Issuance Policy are to:

- Establish conditions for the use of debt;
- Ensure that debt capacity and affordability are adequately considered;
- Minimize the District's interest and issuance costs;
- Maintain the highest possible credit rating;
- Provide complete financial disclosure and reporting; and
- Maintain financial flexibility for the District.

The proposed Debt Issuance Policy that is attached to this staff report, and that should be adopted by resolution:

- Identifies purposes for which debt may be issued;
- Identifies acceptable types of debt;
- Establishes the relationship between the use of debt and the District's budget and capital improvement program;
- Lists policy goals for the use of debt; and
- Discusses necessary internal control procedures for managing debt.

The proposed use of pension obligation bonds that are the subject of this agenda report is consistent with this Debt Issuance Policy.

<u>Resolution Authorizing the Issuance and Sale of a Bond in the Principal Amount Not to Exceed $4,544,000</u>

The proposed resolution authorizes the sale of a bond in the aggregate principal amount of not to exceed $4,544,000. Bond proceeds will be used to pay to CalPERS the amount of the District's unfunded accrued liability and costs of issuance. There is no impact to the FY 2019-20 budget resulting from the transaction. Among the terms of the bond include:

- <u>Maturity:</u> Not later than January 1, 2040.
- <u>Interest:</u> 3.850%
- <u>Optional Redemption</u>: The bond is subject to redemption at the option of the District on or after January 1, 2030.

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. Conversely, if CalPERS exceeds its investment objectives, the District would receive a credit on its pension obligations.

<u>Proposed Pension Obligation Bonds for KPPCSD</u>

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	$4.544 million (approximate including costs of issuance)	$4.5 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

<u>Finance Committee Review</u>

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.*

   <u>Analysis</u>: 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*.

   <u>Analysis</u>: 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.*

   <u>Analysis</u>: 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.

Interest Rate Risk

Like any bond, the transaction has interest rate risk whereby lower interest rates in the future could cause the issuance of POBs to be more lucrative at the District at some future date. Staff believes that the current interest rate environment, and current, significant net present value savings of this proposed transaction merit acceptance of this risk.

In addition, there is also the risk that CalPERS will earn less than 3.85% on its portfolio on a net present value basis over the life of the bonds. In this case, even though the District will still benefit from a fixed interest payment to fund the current UAL, it would arguably be better not to do the transaction. Given historical investment returns by CalPERS, however, staff believes that this risk is also acceptable. Specifically, historical data through FY 2018-19 (last published data available) is as follows (and is shown in the following link):

Total Net Investment Return for CalPERS *(for FY end 6/30)*

FY to date	6.7%
3 years	8.8%
5 years	5.8%
10 years	9.1%
20 years	5.8%
30 years	8.1%

https://www.calpers.ca.gov/docs/forms-publications/facts-investment-pension-funding.pdf

RECOMMENDATION

Discuss the use of pension obligation bonds to fund the current Public Employees Retirement System (PERS) unfunded liability and adopt the following resolutions:

- Resolution Establishing a Debt Issuance Policy for Future Obligations.

- Resolution Authorizing the Issuance and Sale of a Bond in the Principal Amount Not to Exceed $4,544,000 to Refund Certain Pension Obligations of the District, Approving the Form and Authorizing the Execution of a Commitment Letter and Authorizing Actions Related Thereto

ATTACHMENT

- Resolution Establishing a Debt Issuance Policy for Future Obligations.
- Resolution Authorizing the Issuance and Sale of a Bond in the Principal Amount Not to Exceed $4,544,000 to Refund Certain Pension Obligations of the District, Approving the Form and Authorizing the Execution of a Commitment Letter and Authorizing Actions Related Thereto
- Presentation by Kosmont Transactions Services (updated for June 11, 2020 Board meeting)

Prepared and submitted by: Bill Lindsay, Interim General Manager