HUNTINGTON BEACH

Refinancing Our Pension Debt

Addressing HBs Greatest Fiscal Threat

Huntington Beach City Council

November 18, 2019

SUPPLEMENTAL COMMUNICATION

Meeting Date: 11-18-2019

Agenda Item No.: #23 (19-1162)

CalPERS Pension Cost Increases

- The greatest challenge to Huntington Beach's long-term fiscal sustainability – and the fiscal sustainability of government agencies in California – relate to unfunded CalPERS pension cost obligations
- ***CalPERS methodology changes that have been implemented during the past several years have created a pension cost structure that is requiring all California governmental agencies to rethink their operations or face insolvency***

Refinancing Our Pension Debt

- A plan to address our ballooning pension debt costs was presented to both the City Council and Finance Commission in October for consideration
  - City Council Review – October 21, 2019
  - Finance Commission Review – October 30, 2019
- The City Council directed that staff bring back a plan that would allow HB the opportunity to refinance our existing pension debt
- The Finance Commission voted unanimously to recommend that the City Council move forward with the proposed plan

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Pension Cost Background

Unfunded Accrued Liabilities Driving Cost Increases

How Do Pension Costs Work?

- On an annual basis, the City and employees make contributions toward CalPERS to pay for future retirement benefits
  - In total, **the City's account at CalPERS has a balance of around <u>$913.96 million in assets</u>** to pay for promised retirement benefits
- Our **<u>annual payment to CalPERS includes three components</u>**:
  1. Employer Normal Cost
  2. Employee Normal Cost
  3. Unfunded Accrued Liability (UAL) Cost

Three Different Pension Cost Areas

- **<u>Employer Normal Cost (FY 2018/19 actuals - $13.03 million)</u>**
  - Employer pension costs are determined by CalPERS and paid by the City (with a portion being paid by some employees)
    - Misc. employer costs are currently 9.211% of payroll
    - Safety employer costs are currently 19.816% of payroll
- **<u>Employee Normal Cost (FY 2018/19 actuals - $7.60 million)</u>**
  - Employees also contribute towards pension related costs
    - Misc. employees contribute 8% (Classic) or 6.25% (PEPRA) of payroll costs
    - Safety employees contribute 9% (Classic) or 11% (PEPRA) of payroll costs
- **<u>UAL Cost (FY 2018/19 actuals - $24.93 million)</u>**
  - UAL costs are assessed to make up for valuation lost and costs incurred from prior years
    - Lower than projected investment returns
    - Changes in actuarial assumptions

City of Huntington Beach
Pension Cost Areas
FY 2018/19 Actuals

Data Category	Employer Cost	Employee Cost	UAL Cost	TOTAL
Total Contribution	$ 13,031,511	$ 7,603,098	$ 24,930,996	$ 45,565,605
Percentage of Total	29%	17%	55%	100%

UAL Payments Driving Pension Cost Increases

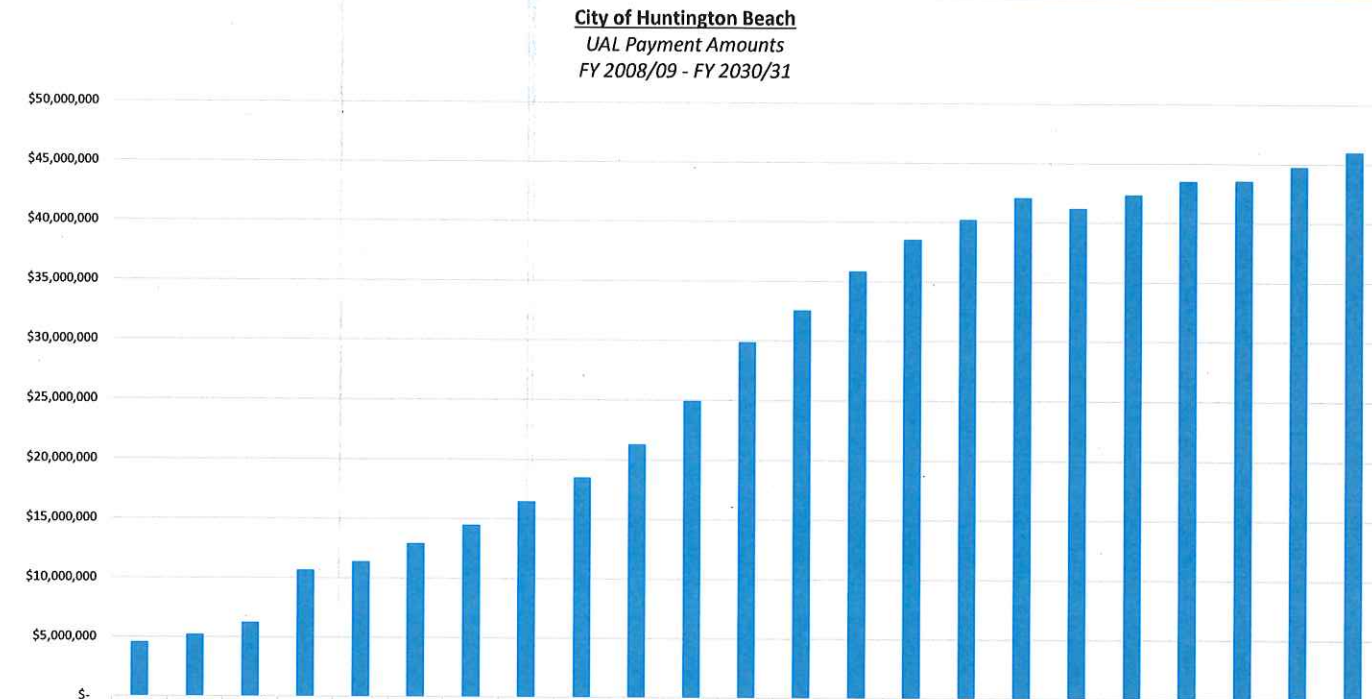
- CalPERS pension **"Normal Cost" are fairly consistent**
  - Public Safety Normal Cost are projected to hover at around 20% – 21% of payroll
  - Misc. Normal Costs are projected to hover at around 10% – 11% of payroll
- **Primary driver of increased pension costs are unfunded liabilities**
  - HB currently has **$913.96 million in assets** in our CalPERS account, however, the value of the retirement benefits that have been promised is currently estimated at **$1.35 billion in liabilities**
- This means that the **City currently has a projected UAL of $436.17 million**
  - The entire **CalPERS portfolio has an estimated UAL of $151.7 billion**
- CalPERS has instituted aggressive funding schedules in an attempt to reach 100% funded status within the next 20-30 years

UAL Structure Similar To A Mortgage

- **Accelerated UAL payments** mandated by CalPERS have been the **cause of our current pension crisis**
- Of note, UAL payments will end when the overall accrued debt load has been paid off
  - In some ways, **UAL payment is similar to a mortgage payment**
- For HB specifically, **our UAL "mortgage" includes the following key terms**:
  - We're being charged an **interest rate of 7%** to service our UAL debt load
  - We have **25 years left on the term** of our current "mortgage"
    - Final payment scheduled for **June 30, 2044**
  - **ARMs stink**... our annual payments will increase through FY 2030/31

UAL Cost Increase Impact On HB

- HB's **annual UAL payment costs (i.e., our mortgage payments) have increased dramatically during the past decade**, and will continue to increase until 2031
  - FY 2008/09 UAL Payment - $4.58 million
  - FY 2018/19 UAL Payment - $24.93 million
  - FY 2030/31 UAL Payment - $46.02 million
- In the **past 10 years (from 2009 – 2019), our annual UAL payment has increased a staggering 444%**, from $4.58 million to $24.93 million
- **By FY 2030/2031, our UAL payment is projected to increase by 85% over FY 2018/19, from $24.93 million to $46.02 million**
  - **This equates to a $21.09 million annual cost increase!!!**



	FY 08/09	FY 09/10	FY 10/11	FY 11/12	FY 12/13	FY 13/14	FY 14/15	FY 15/16	FY 16/17	FY 17/18	FY 18/19
UAL Payment Amount	$4,581,	$5,238,	$6,257,	$10,664	$11,409	$12,920	$14,472	$16,477	$18,500	$21,291	$24,930

	FY 19/20	FY 20/21	FY 21/22	FY 22/23	FY 23/24	FY 24/25	FY 25/26	FY 26/27	FY 27/28	FY 28/29	FY 29/30	FY 30/31
UAL Payment Amount	$29,892	$32,567	$35,873	$38,573	$40,247	$42,107	$41,221	$42,389	$43,555	$43,588	$44,787	$46,019

$21.09 Million / Year

- Moving forward, the challenge we face on the pension front is that **by 2031, our annual UAL payment will <u>increase by $21.09 million / year over FY 2018/19 costs</u>**

CalPERS Overview

How the heck did we get here?

Has CalPERS Always Been Underfunded?

- No! In fact, **20 years ago, CalPERS was 128% funded**
- Also, during the 1990's, and again during the mid-2000's, the CalPERS portfolio was consistently funded at above 80%
- Throughout that period, **on multiple occasions, CalPERS was superfunded**, meaning that it had more than 100% of the assets needed to cover all liabilities

CalPERS Historical Funded Status

So What Happened?

- Our current pension crisis in California began in **September of 1999, when then Governor Gray Davis signed SB 400 into law**
- SB 400 instituted significantly enhanced retirement benefits for CalPERS members
  - Public safety personnel were provided with the "3@50" retirement benefit
  - Non-public safety personnel were offered enhanced pension plans as well
  - These enhanced retirement plans are now near universally provided as standard benefits for public sector employees in California
- **SB 400 significantly increased pension benefits** for public sector employees
  - **Prior to SB 400,** a California Highway Patrol officer who retired with 30 years on the job collected a CalPERS pension averaging $62,218 / year
  - **After SB 400,** California Highway Patrol officers with 30 years on the job began collecting a pension averaging $96,270 / year

CalPERS Investment Returns Tanked

- When SB 400 was instituted, **CalPERS projected that the enhanced benefits could be provided at no additional cost**
  - The CalPERS board assumed ongoing annual investment returns of 8.25%
  - According to actuaries, if investment returns of 8.25% were achieved, then the enhanced retirement benefits would not have added any additional costs
- Unfortunately, **we have had two major stock market collapses since 1999**
  - In 2000, the dot.com bubble burst
    - The Dow Jones Industrial Average dropped 6% in 2000, 7% in 2001, and 17% in 2002
  - In 2008, the Great Recession hit
    - CalPERS investments lost 3% in 2008, and then, lost an unbelievable 24% in 2009
- Today, the overall **CalPERS portfolio is estimated to be funded at around 70%**

CalPERS Cost Increases Enacted

- In response to deteriorating financial conditions, CalPERS has enacted a series of pension cost increases
  - <u>March 16, 2012 – Change in Discount Rate From 7.75% - 7.50%</u>
    - Designed to more accurately reflect investment return earnings
    - Impacted employer rates beginning in FY 2013/14
  - <u>April 17, 2013 – Change in Amortization & Rate Smoothing Policy</u>
    - Designed to pay down unfunded liabilities faster
    - Impacted employer rates beginning in FY 2015/16
  - <u>February 18, 2014 – Change in Actuarial Assumptions & Asset Allocations</u>
    - Designed to account for demographic and mortality adjustments
    - Impacted employer rates beginning in FY 2016/17

Additional Increases Enacted In 2016

- On **December 21, 2016, the CalPERS Board voted to enact two substantial new changes**
    1. Lower the discount rate from 7.5% to 7.0%
    2. Enact an accelerated payback schedule for all unfunded accrued liabilities (UAL)
- The net effect of the two changes includes the following:
    - **Discount Rate Reduction**
        - Designed to more accurately reflect investment return earnings
        - Impacted employer rates beginning in FY 2018/19
    - **UAL Payment Acceleration**
        - Designed to accelerate payments to fully fund existing unfunded liabilities over a 20-30 year period

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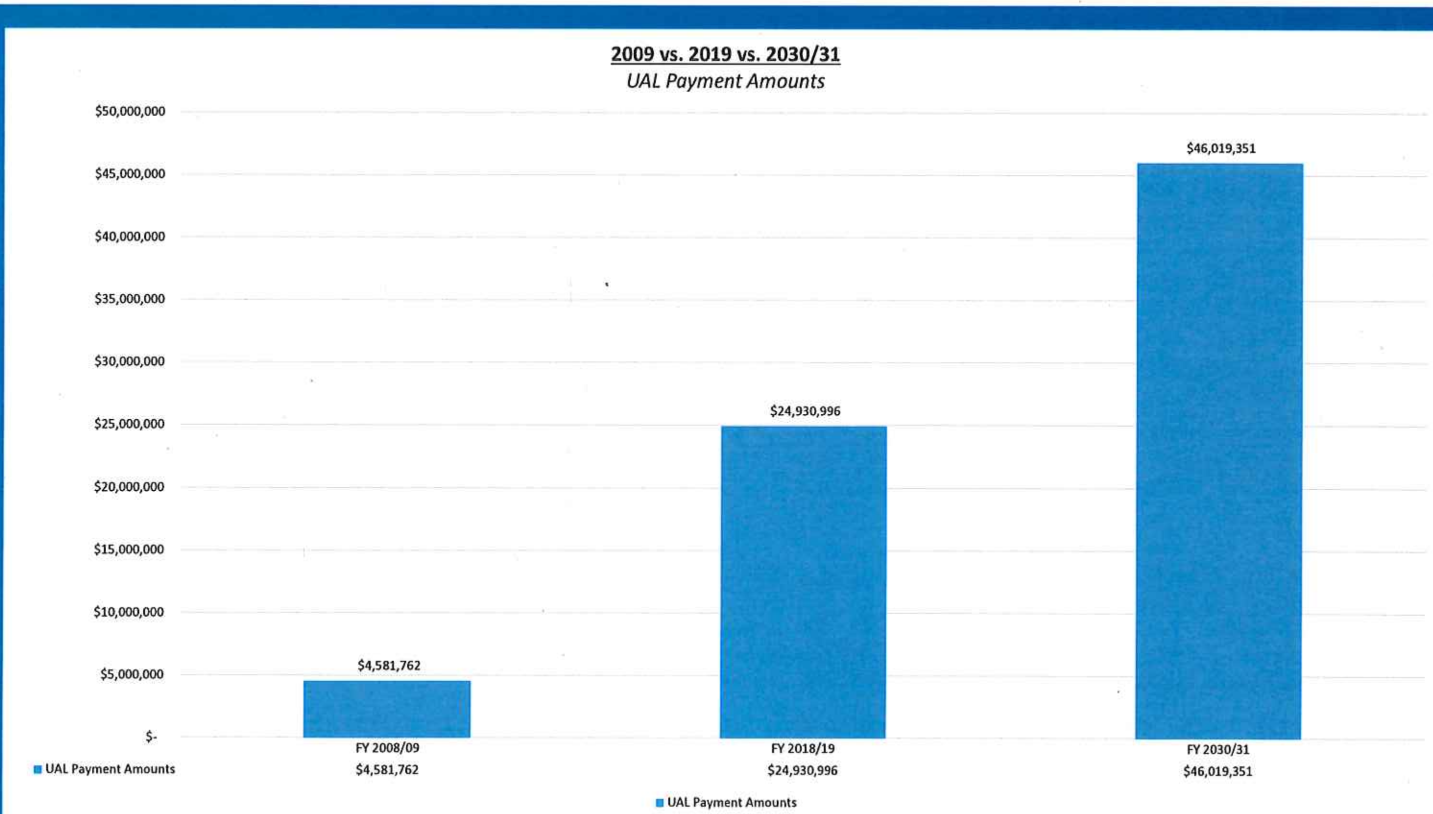
So... What Do We Do Now?

Refinancing our UAL debt, coupled with stronger pension funding policies, are two recommended areas of analysis.

HB's UAL Cost Increase Scale

- <u>2009 vs. 2019 vs. 2030/31</u>
  - FY 2008/09 UAL Payment - $4.58 million
  - FY 2018/19 UAL Payment - $24.93 million
  - FY 2030/31 UAL Payment - $46.02 million
- **From 2009 – 2019, we saw an annualized 444% cost increase**
  - From $4.58 million to $24.93 million
- **From 2019 – 2031, we will see an annualized 85% cost increase**
  - From $24.93 million to $46.02 million
  - **That's a cost increase of $21.09 million / year in 2031**



Scale of Pending Budget Problem

- If we do nothing, by 2031, we will need to find an additional $21.09 million / year to address escalating UAL cost payments
  - **Eliminating our Library, Community Services, and IT Departments would result in <u>$20.81 million in savings</u>**, which isn't enough to cover the UAL cost increase
  - **Eliminating 25% of our entire Police Department operation (~91 positions) would achieve <u>$19.64 million in savings</u>**, which wouldn't be enough to cover the UAL cost increase
  - **Eliminating 40% of our entire Fire Department operation (~79 positions) would net <u>$19.62 million in savings</u>**, which wouldn't be enough to cover the UAL cost increase

What Are Our Options?

- Our pension problem is really a **UAL cost problem**
- To solve the problem, we can either…
  1. Find the funds needed (either through cuts and / or revenue increases) to pay for the increasing UAL costs
  2. **Refinance our current UAL costs via a pension obligation bond (POB)**

Refinancing Seems Like A Good Idea

- **Current CalPERS UAL Balance – $436 million**
- If we do nothing, **our UAL payments to CalPERS during the next 24-year period will cost the City the following amounts**:
  - Annual cost: Fluctuates (avg. $34.79M / year, high of $46.02M / year)
  - Total payments: $834.90 million
  - Total interest costs: $391.78 million
- **Refinancing with a POB could result in the following cost structure during the next 25-year period** (assuming a conservative interest rate of 3.28%):
  - Annual cost: Fixed at ~$27.6 million / year
  - Total payments: $661.8 million
  - Total interest costs: $217.4 million

CalPERS UAL vs. POB Refinance

CalPERS UAL Payment Costs vs. POB Refinancing Costs			
	CalPERS UAL Payment	POB Refinancing	Refinancing Savings
Annual Payment (*average*)	$ 34,787,631	$ 27,575,340	**$ 7,212,291**
Total Payments	$ 834,903,132	$ 661,808,168	**$ 173,094,964**
Total Interest	$ 391,784,473	$ 217,428,168	**$ 174,356,305**

Why Is Refinancing Cheaper?

- One of the **primary cost saving drivers when assessing the POB option is the current municipal bond market**
  - We currently live in a **low-interest rate world**, with certain governmental entities (Germany, Japan, and the EU) offering **negative savings rates**
  - These global market conditions have created a scenario where **municipal borrowing rates are currently near the lowest levels ever recorded**
- For the proposed POB, preliminary research indicates that we could **refinance our UAL debt at somewhere around ~3% interest**
- By comparison, **CalPERS is currently assessing an interest rate of 7% on our UAL debt**

Why Shouldn't We Refinance?

- In order to more fully vet the POB option, staff has been asking ourselves one key question…
  - ***What are the reasons why we SHOULD NOT issue a POB?***

Reasons Why Refinancing Could Be A Bad Idea

- Issuing a POB now **does nothing to address future possible unfunded actuarial liabilities growth**
  - Returning our UAL to zero now does nothing to keep it at zero in the future
- **CalPERS could underperform from an investment perspective**, and our POB funds could lose value
  - If CalPERS does not earn at least a ~3% return (i.e., the cost of refinancing our UAL debt), then our POB funds will cost more than the benefit we are receiving

Reasons Why Refinancing Could Be A Bad Idea

- **CalPERS could over-perform from an investment perspective**, and we wouldn't have had to issue such a large POB
  - If CalPERS over-performs and beats 7% investment returns (6.7% return earned in FY 2018/19), then our UAL amount will decrease
- Unknown **possible State legislative / judicial changes** in the future
  - The State and / or the Courts could make pension rule changes to reduce our UAL amounts

Reasons Why Refinancing Makes Sense

- Despite the reasons identified as to why we shouldn't consider refinancing our UAL debt, there **continue to be compelling reasons why we should consider the strategy**
  - Refinancing removes **an unknown cost variable and replaces UAL cost increases with a stable fixed payment amount**
    - Similar to transitioning from a variable rate ARM loan into a fixed-rate loan
  - **Interest rates are at historic lows**, and given HB's current fiscal situation, we will likely be able to refinance our UAL debt load at an interest rate of ~3%

Reasons Why Refinancing Makes Sense

- **More than likely, CalPERS will be able to earn an investment return of at least (and likely greater than) 3%**, which makes refinancing an attractive option
  - CalPERS actual investment return performance (for FY ending 6/30/19):
    - Last year (FY 2018/19) – 6.7%
    - Last 3 years – 6.7%
    - Last 5 years – 8.1%
    - ***Last 10 years – 5.6%***
    - Last 20 years – 6.1%
    - Last 30 years – 8.4%
- Even if the State / courts make pension program changes (which is unlikely), HB could still take advantage of those options if we refinance
  - **Refinancing our UAL debt does not preclude the City from taking part in future State / court decisions related to pension program changes**

Reasons Why Refinancing Makes Sense

- **If our pension fund becomes over-funded (at +100%), those funds stay in the City's CalPERS account** and can be used to cover future UAL shortfalls
- By refinancing, the **City's CalPERS pension fund will have a larger pool of assets to invest with**, and given compounding interest, that larger asset pool gives HB a better chance to earn more significant returns
  - 7% return on $913.96 million (current CalPERS balance) = $63.98 million
  - 7% return on $1.35 billion (CalPERS balance if fully funded) = $94.51 million

Additional Refinance Consideration

- Staff has spent significant time researching why some state pension funds are currently better funded than CalPERS, and why certain local jurisdictions in California have lower UALs than others
  - **New York vs. California**
    - In 2019, NY = 96% funded // California = 70% funded
    - State of California – Brown + Newsom = $9 billion "POB" to pay down State UAL
  - **California city examples**
    - Newport Beach – $8M - $9M extra per year to pay down UAL
    - Santa Monica – Paid down UAL by $77.5M from 2010 - 2018 with cash on hand
    - Ontario / Simi Valley – Considering refinancing w/ POB option to pay down UAL

Savings From Refinancing UAL Debt Should Be Conservatively Managed

- **If we do move forward** with refinancing our existing UAL debt, staff would recommend that we **conservatively manage any realized savings**
- <u>Fiscal threats are on the horizon</u>
  - **CalPERS will almost certainly look to** <u>lower their assumed rate of return</u> from 7% down to 6% within the next few years
  - We are currently in our **<u>125th consecutive month of economic expansion</u>**, making this current period the longest growth cycle in the history of our nation
    - Growth cycles in the US have historically averaged 56 months in length
    - <u>We are overdue for a recession, which is looming over the world</u>

Development Of A CalPERS UAL Policy

- In addition to using our Section 115 Trust, if we do move forward with refinancing our UAL debit, staff also would recommend that a new **City UAL policy be adopted**
- Such a policy could require that as part of our budget process, we **annually identify any new UAL debt that has accrued**, and that the City **develop a pay-off plan for the new debt within a set time period**
- For example, a policy framework could be as follows:
  - UAL of $0 - $5 million - paid off within 0-5 years
  - UAL of $5 - $10 million - paid off within 5-10 years
  - UAL of $10 - $15 million - paid off within 10-15 years
  - UAL of $15 - $20 million - paid off within 15-20 years

Requested City Council Action

1. Approve the resolution and trust agreement necessary to **initiate the judicial validation process** to allow HB the opportunity to refinance our UAL debt
   - Refinancing would be achieved through a pension obligation bond (POB)
   - In California, **POBs require a judicial validation action,** which requires around 90-days to coordinate
   - To proceed, **the City must adopt a non-binding resolution authorizing the pension obligation bond process**
2. If the resolution and trust agreement are approved by City Council, the following will take place:
   - Judicial validation process will be initiated
   - City financing team will prepare all required financial documents necessary to **bring the item back for City Council consideration in March / April 2020**

Questions?