MINUTES
FINANCE COMMISSION

Wednesday, October 30, 2019 - 7:00 P.M.
City of Huntington Beach
Civic Center – Lower Level Conference Room #B-7
2000 Main Street
Huntington Beach, CA 92648-2702

Chair Sterud called the Special Meeting to order at 7:00 p.m. and Commissioner Van Der Mark led the Pledge of Allegiance.

MEMBERS PRESENT:	Sterud; Romero; Van Der Mark; Hudson
MEMBERS ABSENT:	Lo Grasso; Bunten; Gledhill
STAFF PRESENT:	Oliver Chi, City Manager Dahle Bulosan, Acting Chief Financial Officer Sunny Rief, Acting Assistant Chief Financial Officer Thuy Vi, Administrative Assistant, Finance Linda Wine, Administrative Assistant, Finance

ORAL COMMUNICATIONS – None.

MINUTES

Following a pre-meeting discussion between Chair Sterud and Acting Chief Financial Officer Bulosan, it was agreed that the Finance Commission Meeting Minutes dated July 24, 2019 are approved as presented at the September 25, 2019 Finance Commission Meeting as follows:

Motion: Moved by Lo Grasso and seconded by Bunten to approve the Finance Commission Meeting Minutes dated July 24, 2019, as presented

Ayes:	Lo Grasso; Bunten; Van Der Mark
Noes:	None
Abstain:	Sterud, Gledhill, Hudson
Absent:	Romero
Approved:	***3-0-4 (Sterud, Gledhill, Hudson-Abstain, Romero-Absent)***

Motion: Moved by Hudson and seconded by Romero to approve the Finance Commission Meeting Minutes dated September 25, 2019, as presented

Ayes:	Sterud; Romero; Van Der Mark; Hudson
Noes:	None
Abstain:	None
Absent:	Lo Grasso; Bunten; Gledhill
Approved:	***4-0-3 (Lo Grasso, Bunten, Gledhill-Absent)***

PRESENTATIONS

City Manager Oliver Chi gave a presentation on the City's CalPERS Unfunded Accrued Liability (UAL). Chi stated that pension cost increases are an existential threat. 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.

Chi provided a summary of the pension cost background. Annually, the City and employees make contributions toward CalPERS to pay for future retirement benefits. The City's CalPERS account has a balance of approximate $913.96 million in assets to pay for promised retirement benefits.

The City's annual payment to CalPERS includes three components consisting of: (1) Employer Normal Cost; (2) Employee Normal Cost; and (3) Unfunded Accrued UAL Cost.

Chi noted that there are three different pension cost areas:

1. Employer Normal Cost (FY 2018/19 actuals - $13.03 million). Employer pension costs are determined by CalPERS and paid by the City (with a portion being paid by some employees).
2. Employee Normal Cost (FY 2018/19 actuals - $7.60 million). Employees also contribute towards pension related costs.
3. UAL Cost (FY 2018/19 actuals - $24.93 million). UAL costs are assessed to make up for valuation lost and costs incurred from prior years as a result of lower than projected investment returns and changes in actuarial assumptions.

Chi indicated that UAL is driving cost increases. CalPERS pension "Normal Costs" are fairly consistent. The primary driver of increased pension costs are unfunded liabilities. The City 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.

Chi stated that accelerated UAL payments mandated by CalPERS have been the cause of the City's current pension crisis. He noted that UAL payments will end when the overall accrued debt load has been paid off.

Chi noted that in some ways, UAL payment is similar to a mortgage payment. The City's UAL "mortgage" includes an interest rate of 7% to service our UAL debt load, and we have 24 years remaining on the term of our current "mortgage," with our final payment scheduled for June 30, 2043. The City's annual payments will increase through FY 2029/30

Chi explained the UAL Cost increase impact on Huntington Beach. The City's annual UAL payment costs (i.e., our mortgage payments) have increased dramatically during the past decade, and will continue to increase until 2030. In the past 10 years (from 2009 – 2019), the

City's annual UAL payment has increased 444%, from $4.58 million to $24.93 million. By FY 2029/30, the City's 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. Between 2009-2030, the City's UAL costs will have increased 904%, with annual costs having increased by $41.44 million.

Chi stated that moving forward, the challenge the City faces on the pension front is that by 2030, our annual UAL payment will increase by $21.09 million/year over current costs.

Chi provided a CalPERS overview, noting that CalPERS has not always been underfunded. Twenty years ago, CalPERS was 128% funded. The current California pension crisis began in September of 1999, when then Governor Gray Davis signed SB 400 into law, which instituted significantly enhanced retirement benefits for CalPERS members and significantly increased pension benefits for public sector employees. When SB 400 was instituted, CalPERS projected that the enhanced benefits could be provided at no additional cost, and 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. Two major stock market collapses have occurred since 1999. In 2000, with 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, and CalPERS investments lost 3% in 2008, and 24% in 2009. Today, the overall CalPERS portfolio is estimated to be funded at around 70%.

In response to deteriorating financial conditions, CalPERS has enacted a series of pension cost increases:

March 16, 2012 – changed discount rate from 7.75% - 7.50%; designed to more accurately reflect investment return earnings, and impacted employer rates beginning in FY 2013/14

April 17, 2013 – changed amortization and rate smoothing policy; designed to pay down unfunded liabilities faster, and impacted employer rates beginning in FY 2015/16

February 18, 2014 – changed in actuarial assumptions and asset allocations; designed to account for demographic and mortality adjustments, and impacted employer rates beginning in FY 2016/17

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%; and (2) enact an accelerated payback schedule for all UAL. The net effect of the two changes includes the following:

1. Discount Rate Reduction - designed to more accurately reflect investment return earnings and impacted employer rates beginning in FY 2018/19.

2. UAL Payment Acceleration - designed to accelerate payments to fully fund existing unfunded liabilities over a 20-30 year period.

Chi outlined the City's UAL cost increase scale:

<u>2009 vs. 2019 vs. 2029/30</u>

- FY 2008/09 UAL Payment - $4.58 million

- FY 2018/19 UAL Payment - $24.93 million
- FY 2029/30 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 – 2030, we will see an annualized 85% cost increase from $24.93 million to $46.02 million, which is a cost increase of $21.09 million/year in 2030.

By 2030, the City will need to find an additional $21.09 million/year to address escalating UAL cost payments. Chi stated that eliminating City services would not be enough to cover the UAL cost increase. He noted that eliminating our Library, Community Services, and IT Departments would only result in $20.81 million in savings. Eliminating 25% of our entire Police Department operation (91 positions) would only achieve $19.64 million in savings. Eliminating 40% of our entire Fire Department operation (79 positions) would only net $19.62 million in savings.

Chi stated that the magnitude of $21.09 million/year also dwarfs the impact that the Great Recession had on the City. The effects of the Great Recession were first felt in Huntington Beach in FY 2008/09, as combined Property Tax & Sales Tax revenues dropped by 1.7%.

Chi discussed options, and recommends refinancing the City's UAL debt and stronger pension funding policies. By 2030, the City will need to find an additional $21.09 million/year to address escalating UAL cost payments.

Chi stated that 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; or (2) refinance our current UAL costs via a pension obligation bond (POB).

The City's current CalPERS UAL Balance is $436 million. 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 24-year period (assuming a conservative interest rate of 3.16%):

Annual cost:	Fixed at $26.26 million/year
Total payments:	$630.28 million
Total interest costs:	$192.12 million

Chi discussed why refinancing is cheaper. He stated that one of the primary cost savings driver 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. 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?

Chi outlined the reasons why refinancing might be a bad idea. He noted that issuing a POB now does not address future possible unfunded actuarial liabilities growth. Returning our UAL to zero now does not 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. CalPERS could over-perform from an investment perspective, and we would not 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. The possible State legislative/judicial changes in the future are unknown. The State and/or the Courts could make pension rule changes to reduce our UAL amounts.

Chi also outlined reasons why refinancing makes sense. He noted that 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. Refinancing is similar to transitioning from a variable rate adjustable rate mortgage (ARM) loan into a fixed-rate mortgage loan. Interest rates are at historic lows, and given the City's current fiscal situation, we will likely be able to refinance our UAL debt load at an interest rate of 3%.

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, 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.

It is unlikely that the State/courts will agree to a pension program fix within the next few years. Without refinancing our UAL debt, within the next few years, Huntington Beach will need to institute more draconian measures or run the risk of running out of cash. 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

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

Chi stated that 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. Fiscal threats are on the horizon, and CalPERS will almost certainly look to lower their assumed rate of return from 7% down to 6% within the next few years. We are currently in our 124th consecutive month of economic expansion, making this current period the longest growth cycle in the history of our nation. Growth cycles in the U.S. have historically averaged 56 months in length. We are overdue for a recession, which is looming over the world.

Chi discussed the City's Section 115 Trust and listed its benefits and limitations.

Benefits:
- Assets can theoretically be accessed to pay CalPERS at any time
- Provides access to a broader base of investment options than allowed by City investment policy
- Can serve as a rainy-day-fund to help offset pension costs
- More control over investments when compared with paying CalPERS directly
- Provides diversification of investment assets and strategies

Limitations:
- Assets not recognized when CalPERS sets contribution rates
- Investment returns (net of expenses) likely to be lower than if invested directly with CalPERS
- Given scale of City's CalPERS portfolio ($914M), Trust is not likely to have a material impact on pension asset diversification
- Assets can't simply be transferred to CalPERS, they have to be sold at market value
- In a downturn, when reserve funds are likely to be needed most, market value of the portfolio will likely be negatively impacted

Chi noted that 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

Chi reviewed the proposed next steps, and stated that staff is currently conducting further analysis and outreach regarding refinancing our UAL debt load. Staff is also working to initiate the judicial validation process needed to allow the City the opportunity to refinance our UAL debt. The agenda item will likely be presented to Council for review on November 18, 2019. A POB is the instrument through which the refinancing would be achieved. In California, POBs require a judicial validation action, which requires around three months to coordinate. To proceed, the City will be required to adopt a non-binding resolution authorizing the POB process.

DISCUSSION ITEMS AND POTENTIAL RECOMMENDATIONS

Motion: Moved by Sterud and seconded by Romero to recommend to the City Council that they take the next steps to approve the refinancing of the City's CalPERS Unfunded Accrued Liability (UAL) debt, currently $436M, through a pension obligation bond

Ayes:	Sterud; Romero; Van Der Mark; Hudson
Noes:	None
Abstain:	None
Absent:	Lo Grasso; Bunten; Gledhill
Approved:	***4-0-3 (Lo Grasso, Bunten, Gledhill-Absent)***

COMMISSIONER COMMENTS

The Finance Commission welcomed Chi as the new City Manager, and congratulated Bulosan and Rief on their new positions.

ADJOURNMENT – There being no further business, the meeting adjourned at 8:30 p.m.

Submitted by:

Dahle Bulosan, Acting Chief Financial Officer

By: Thuy Vi, Administrative Assistant, Finance Department
Linda Wine, Administrative Assistant, Finance Department