DATE: April 19, 2022

TO: Mayor and City Council

FROM: Director of Finance

SUBJECT: CalPERS Pension Unfunded Accrued Liability (UAL) Update and Analysis of Restructuring Concepts

RECOMMENDATION

That the Council receives this report and considers whether a future agenda item is desired to direct staff to continue exploring pension restructuring options.

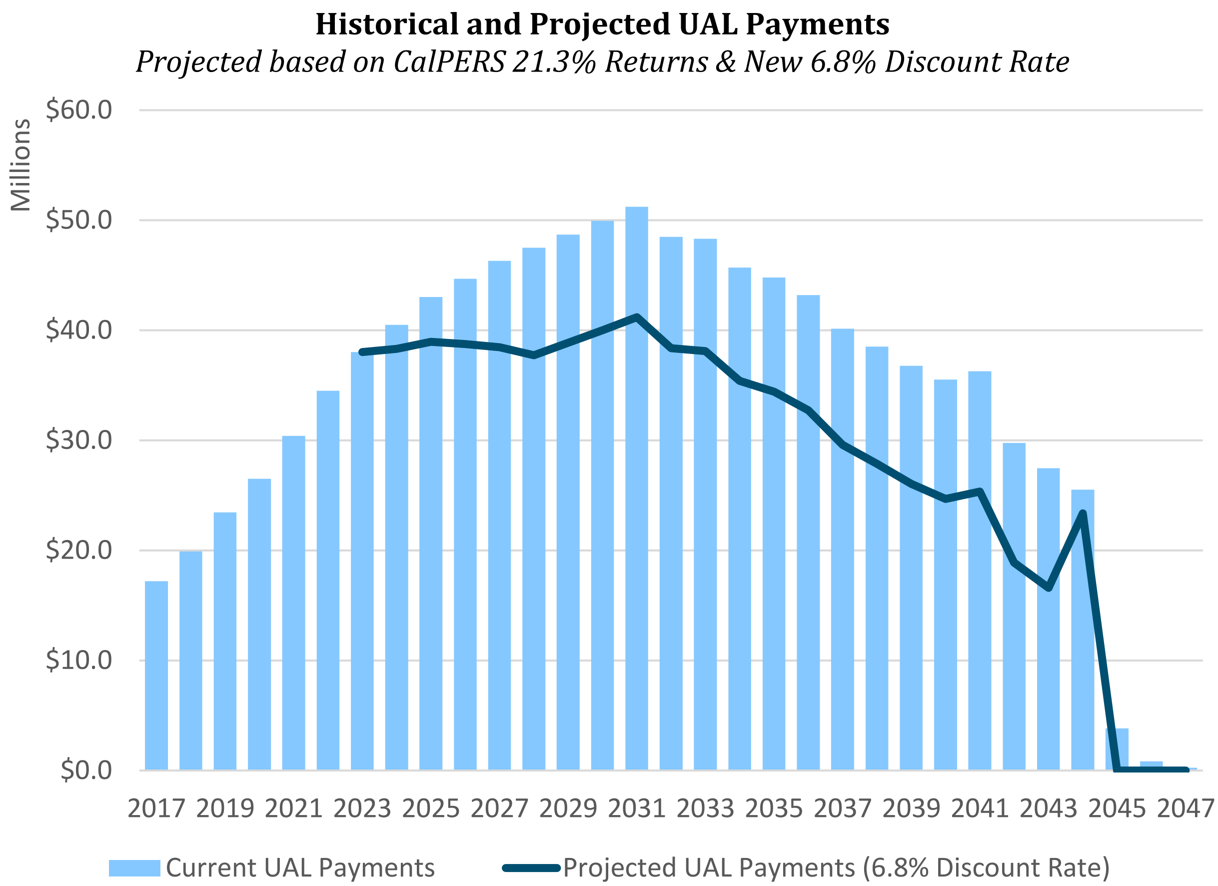
SUMMARY

The City has been diligent about monitoring changes at CalPERS over the last several years, providing regular updates to the Council Budget and Finance Committee (Committee) and Council, as well as factoring these changes into the City's budget and projections. With interest rates at historically low levels, many agencies (>85) in California have recently restructured a portion of their UAL at significantly lower interest rates (vs. the 6.8% that CalPERS is charging the City on this debt) to achieve financial savings, enhanced budgetary predictability, and future fiscal sustainability. This presentation was originally presented to the Committee on March 16th, with unanimous guidance from the Committee to bring it forward to the full Council.

BACKGROUND

In spite of making CalPERS required contributions over the last 8 years, the City's UAL for its CalPERS Miscellaneous and Safety Plans has grown 75%, from approximately $282 million to $493 million. This UAL represents the shortfall/gap between what is needed to pay retiree benefits versus how much in current assets the City actually has in its accounts with CalPERS. The UAL has rapidly increased primarily due to CalPERS investment underperformance and changes to its actuarial assumptions, primarily the discount rate. The discount rate is what CalPERS expects to earn annually, as well as the interest rate that it charges its member agencies on this UAL debt. That discount rate was over 8% in the early 2000s and has been reduced several times over the last 15 years. In November 2021, CalPERS reduced the discount rate from 7.0% to 6.8%. Lowering of the discount rate results in increases to the City's contributions to its CalPERS retirement plans given that less is expected from earnings on the investments.

As shown in the chart below, the City's annual UAL payments have increased from about $17 million in FY 2017, to over $34 million in FY 2022. Based on the most recent report, they are projected to grow to $50 million by FY 2030.



While not yet reflected in the recent actuarial report, the City's overall UAL is expected to decrease to about $414 million (from $493 million) once the new reports are released late this year as the strong 21.3% investment gains from FY 2021 and the new 6.8% discount rate get incorporated. Based on this projected UAL reduction, it is anticipated that the increase in annual UAL payments will be less rapid (projected new peak of $38 to $41 million over the next decade). However, the reduction in the discount rate to 6.8% will also increase the City's **Normal Cost**, which is separate from the UAL, and relates to the annual pension costs for current employees. These costs are expected to rise from the current annual level of $15 million, to $17 million by FY 2023/24, offsetting a portion of the expected reduction in UAL payments resulting from the 21.3% investment gain.

Additionally, it is possible that CalPERS will underperform its target of 6.8% earnings for FY 2022 based on the recent stock and bond market declines, meaning that the City's UAL could potentially jump back up to previous levels (or higher). As of the first week of April, it is estimated that CalPERS is only at about 1% earnings for FY 2022. Rising pension costs are a widespread issue facing all municipalities nationally and developing a multi-pronged cost management strategy is highly recommended by staff and NHA.

DISCUSSION

Several cost management strategies will be discussed in the presentation. However, the focus will be on the concept of restructuring the UAL given the complexity associated with this strategy and longer timeline to fully explore in a more comprehensive way if the Committee and Council desires to. A UAL Restructuring would entail converting higher interest rate debt with CalPERS (6.8%) to lower interest rate debt (current market rates between 4.00% and 4.75%). While a significant amount of additional due diligence and analysis (including a thorough risk assessment) needs to be completed, the primary benefits of this option include:

- **Fiscal Sustainability Tool:** Ability to "re-shape" the City's overall pension repayment in a way that creates enhanced long-term fiscal sustainability, budgetary predictability, and enhanced resiliency to future economic shocks.
- **Financial/Budgetary Savings:** By reducing the City's pension payments to lower levels, a significant amount of cash flow savings is projected for the City's General Fund and other utility funds that could be used to address other City priorities (e.g., continue critical services to the community, sustain reserves, and funding capital and infrastructure needs).
- **Interest Rate Savings "Arbitrage":** City can borrow at rates much lower (currently ≈ 4.00% to 4.75% depending on term and credit) than the current CalPERS rate (6.80%). Similar to refinancing a higher interest rate mortgage or credit card, a UAL Restructuring would allow the City to convert higher interest rate debt to lower interest rate debt and create a significant amount of projected savings on its debt payments.
- **Increase Funding Ratio:** Current funding levels (investments to liabilities) for the City's CalPERS retirement plans are only about 60% to 64%; issuing a Public Obligation Bond (POB) could increase the ratio to healthier levels (85% to 100%), helping to ensure the long-term viability of the retirement program.
- **Modify Maturity:** Shorten or lengthen repayment period as deemed most fiscally appropriate.
- **Leverage Savings through Improved Policies:** Council and staff can memorialize the intended uses of potential savings through new adopted policies if desired.

Recent UAL Restructurings: With interest rates dropping to historically low levels in the last couple years, combined with strong investor interest, pension bond issuance has significantly increased (since 2020) with over 85 CalPERS members (mostly cities) having restructured their UAL for a total estimated UAL refinanced of about $8 billion. Examples include San Ramon, Corte Madera, Poway, La Habra, Oroville, Fort Bragg, National City, Paramount, Bellflower, Lakeport, Montclair, Corona, Santa Ana, Orland, Commerce, San Anselmo, Sanger, San Fernando, Buena Park, Redondo Beach, Covina, Whittier, El Segundo, Auburn, Willows, Corte Madera, Manhattan Beach, Orange, Ukiah, Chula Vista, Downey, El Cajon, Coachella, Gardena, Arcadia, Placentia, Torrance, Azusa, Larkspur, Marysville, Grass Valley, Riverside, Pomona, West Covina, Ontario, Carson, Pasadena, Glendora, Hawthorne, La Verne, Maywood, El Monte, San Fernando, Montebello, Huntington Beach, Monrovia, and Inglewood.

Interest rates for these recent financings ranged from 2.54% to 4.25%, with rates dictated by market conditions at the time of pricing, credit rating of the issuer, and length of term of the bonds. Unfortunately, interest rates for these types of bonds have risen by about 1.50% over the last 4 months given inflationary fears, federal reserve interest rate hikes, and volatility from the Ukraine/Russian war. Interest rates are projected to continue to be volatile for the next couple of years and something that the City and NHA would consistently monitor to better assess the potential benefits of this restructuring concept.

Reinvestment Risk: Actual savings from the restructuring will be dependent on two factors: (1) actual interest rates at the time of pricing and (2) future CalPERS returns, which is unknown at the time of bond issuance. Generally speaking, the City will be better off if CalPERS earnings rate exceeds the pension bond interest rate (4.00% - 4.75%) over the term of the financing. While past performance doesn't guarantee future results, CalPERS average historical returns are 6.9% (last 20 years) and 8.4% (last 30 years).

Assessing and mitigating reinvestment risk would be a key objective as the City and its financing team evaluate and refine restructuring options for the Committee and Council's consideration if this evaluation process were to continue. A preliminary stress-testing (risk assessment) has already been conducted and was shared during the Committee workshop presentation. More robust stress testing could be conducted during a more comprehensive evaluation process this Spring/Summer and could quantify several downside scenarios. This includes modeling out impacts if there were to be another 2008-like recession, or other CalPERS underperformance scenarios where they consistently underperform their target returns. Based on this risk assessment, or changing market conditions (i.e., rising interest rates), it may be recommended that the City not pursue a restructuring at that time. Given the recent rise in rates, combined with the increased likelihood of a recession in the next couple of years, some agencies are considering delaying their UAL restructuring transactions or even staggering them out over several years to mitigate risk. All these types of considerations would be evaluated during the judicial validation process, which is explained in more detail below.

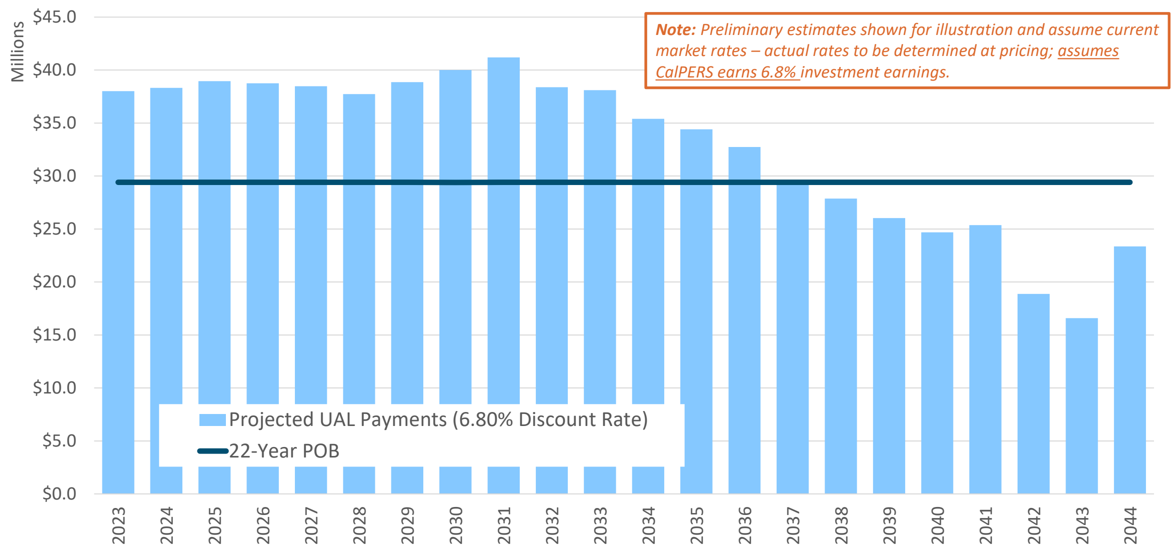
A UAL restructuring is most often executed using a Pension Obligation Bond (POB) structure. POBs are a particular kind of taxable bond where the proceeds are dedicated entirely to the government's pension obligations. The goal is that the return on the proceeds that they have invested in the pension system will be higher than the interest cost on the related debt over the long run. The issuance of a POB is viable only after a judicial validation process is completed (in Alameda County Superior Court). The validation process typically takes three to four months to complete. This process does not lock the City into issuing a POB, but it does provide the City with the option to do so at anytime in the future (subject to future Council approvals). Given the recent upward pressure on interest rates, and the ability to continue a robust financial evaluation process and investigation of all cost management strategies concurrently with this validation process, initiating a validation process soon is something that the City may want to consider in order to make a POB a viable option in the future.

ECONOMIC IMPACT

Based on preliminary analysis, a restructuring of the UAL could produce significant savings for the City. As outlined in the graphic below (dark blue line), payments could be smoothed out at a lower level. Based on this preliminary option, projected cash flow savings are shown in the table at the bottom of the page, which total about $75 million (over $8 million annually for next 14 years).

Preliminary UAL Restructuring Option for City of Hayward

22-Year Term with Level Payments



Metrics	22-Year POB
UAL Funded ($)	$413,980,000
% UAL Funded (Current Asset Valuations)	84%
Funded Ratio (Current Asset Valuations)	94%
% UAL Funded (Projected After FY 2021 Returns & 6.8% Discount Rate)	100%
Funded Ratio (Projected After FY 2021 Returns & 6.8% Discount Rate)	100%
Maturity	22 Years
Average Life	13 Years
All-In Interest Rate	4.33%
PV Savings (%)	16.96%
PV Savings ($)	$70,226,988
Cumulative Savings*	$74,592,521
Savings (2023-2036)*	$117,540,918
Potential Average Annual Savings (2023-2036)*	$8,395,780

**The amounts shown are estimates*

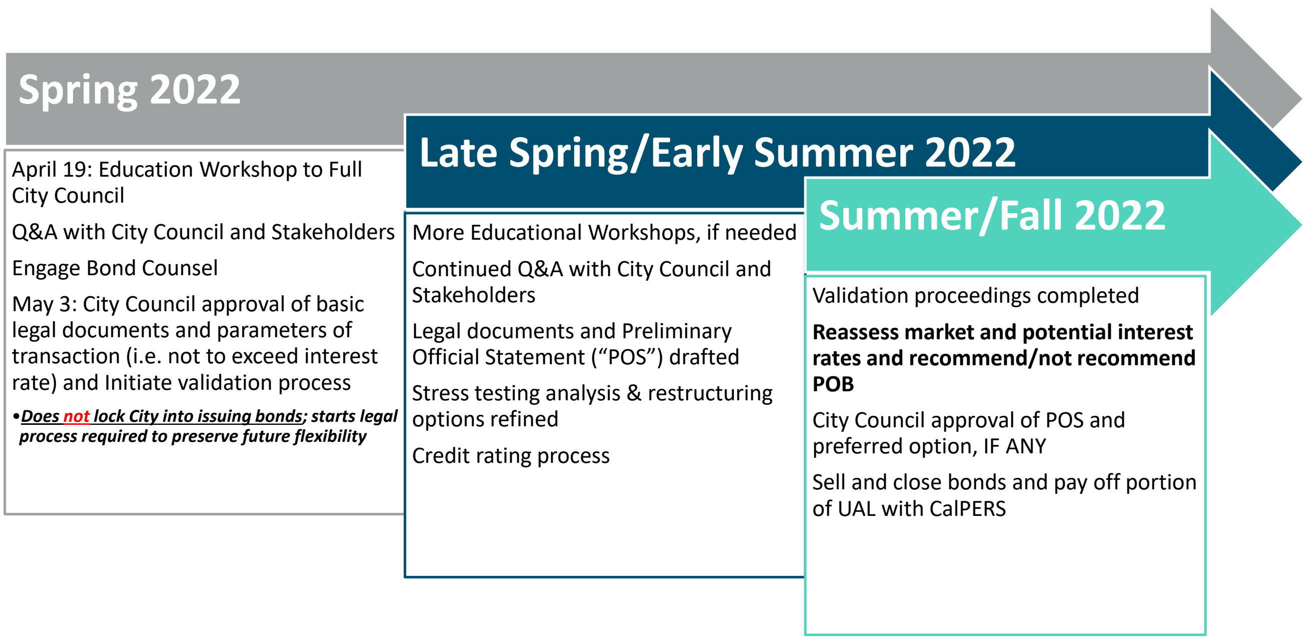
Note: Preliminary estimates shown for illustration and assume current market rates – actual rates to be determined at pricing; assumes CalPERS earns 6.8% investment earnings.

As noted in the Committee presentation, there are a myriad of structuring options for a potential POB. All sizes could be explored (as small as 25% of the City's UAL, up to 100%), as well as varying terms (lengths of repayment) and repayment shapes (i.e. level vs. escalating) that are tailored to the City's budgetary goals and constraints. This "base case" option above is included in order to provide the potential benefits of the UAL restructuring, while not overcomplicating the initial discussion with too many options.

NEXT STEPS

If Council wishes for staff to initiate a validation process, it is estimated that this could happen at a Council meeting in the coming weeks, which would start the validation process timeline. While that process runs its course (estimated to be 3-4 months), City staff would recommend a robust evaluation process for developing a multi-pronged cost management strategy to address these rising pension costs. Options would be evaluated in more detail this spring and summer, with the pros, cons, and risks illuminated in greater detail. Once the validation process is completed, the City would have the opportunity to issue a POB if it desired to; however, market conditions may be significantly different at that time and a UAL restructuring may not be recommended.

Potential Timeline:



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