CITY OF MANHATTAN BEACH
PENSION OBLIGATION BONDS – OCTOBER 2020
FREQUENTLY ASKED QUESTIONS

What are City pension costs?

The City contracts with CalPERS to offer a defined benefit retirement plan to full-time City employees. Benefit formulas are based on years of service, age at retirement, and final actual annual compensation. Benefit formulas vary by Classification ("Miscellaneous" or "Public Safety") and by the date an employee entered into CalPERS membership ("Classic" or "PEPRA", if 2013 or later).

Who contributes to the cost of the City's employee pension benefits?

Pension benefits are funded by City and Employee contributions, as well as investment earnings achieved by CalPERS. The City and active employees pay annual contributions as a percent of payroll. These contributions are referred to as "normal" annual service costs.

City and Employee contributions are calculated by CalPERS, however, the City may negotiate with employees to pay higher contribution rates. Currently, public safety employees pay an additional 3% over the required normal cost rate required by CalPERS.

Contributions to amortize unfunded actuarial liability (UAL) are by law, the sole responsibility of the City

How are the City's pension costs calculated?

There is a base cost contribution - "normal cost or service cost" which is the accrued liability generated by active employees in the current fiscal year. The contribution is based on a percent of payroll and are made by both employee and employer. Normal Pension contributions are calculated by CalPERS and based on demographic and financial information as of a certain date. The calculations include demographic and economic assumptions for the future, such as how much CalPERS will earn on its investment portfolio of $400 billion. CalPERS actuaries assume the discount rate will remain at 7% going forward and that the realized rate of return on assets for subsequent fiscal years is also 7%. When actual investment returns are below the assumed rate of return, an unfunded accrued actuarial liability (UAL) is created and future required contributions are necessary to amortize the UAL. When actual investment returns are above the assumed rate of return, a negative UAL is generated and is amortized by reduction in employer normal contribution rate. future required contributions will decrease.

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What is an Unfunded Accrued Liability (UAL)?

In addition to City and Employee "normal cost" pension contributions, the third component to funding long-term pension liabilities is investment returns. CalPERS invests contribution payments with the goal of earning sufficient returns over the long-term to pay defined benefits as promised and cover CalPERS' expenses. When investment earnings do not meet expectations over extended periods - an unfunded accrued actuarial liability is generated.

When the market value of assets is less than the City's accrued liability (debt), the difference is called an Unfunded Accrued Liability (UAL). If the City has an unfunded liability, then the City must pay additional contributions.

What are Pension Obligation Bonds?

A public finance strategy and tool that state and local governments can use to issue taxable debt that extinguishes some or all of the public agency's unfunded accrued liability ("UAL"). Pension Obligation Bond proceeds would be deposited with the City's pension system, CalPERS, and invested along with other pension system assets. Debt service payments to bondholders would replace the City's UAL payments to CalPERS.

POBs are only advisable when the all-in interest rate of the bond issue is significantly below the actuarial rate of interest factored into the calculation of the UAL (currently 7%).

Pension Obligation Bonds do involve investment risk. If invested bond proceeds yield high returns, the pension system could be "overfunded". In that case City normal cost rate would be adjusted downward. However, should the City's assets ever exceed liabilities, those funds will stay in the City's CalPERS account and be used to cover future UAL shortfalls.

Is there a "good time" and a "bad time" to issue POBs? Does the economic cycle factor in?

Yes. The economic cycle can be a deciding factor on whether POBs should be issued. Long-term POB savings depend on long-term investment returns. POBs "make sense" if the investment earnings exceed the cost of borrowing over the long-term.

If POBs are issued with an interest rate higher than the interest rate that CalPERS charges the City (currently 7%), then no savings would result. However, if the City issued POBs with a fixed interest rate lower than CalPERS' 7% rate, then the difference in how much the City will repay bondholders will be less than what the City would have paid to CalPERS. With the City's AAA rating, the City could issue POBs at an all-in interest cost as low as 3.1%, which would save the City roughly $31 million in present value savings (interest costs) over the next twenty-five years.

What about stories in the news of cities issuing POBs but then owing money to bondholders and CalPERS?

There are examples of governmental agencies running into financial trouble even after issuing POBs. Examples often cited in the news are the cities of Oakland and Stockton. When comparing to the City of Manhattan Beach's current financial position, key differences to these historical references include the timing of their bond issues to the economic cycle.

Both Stockton and Oakland issued POBs to prepay their current UAL. After the issuance Cal PERS experienced significant market losses on its investment portfolio. If Stockton and Oakland had not issued POBs, they would have accrued the same additional UAL to their existing balance to CalPERS.

Are Pension Obligation Bonds "new debt" for the City?

No. The current UAL is a debt already owed by the City to CalPERS and is recognized in our Balance Sheet. With the issuance of POBs, the current UAL debt owed to CalPERS is exchanged for debt to bondholders. POBs are not new debt or additional debt, they replace our current debt at a lower cost.

Can the City's UAL increase in the future?

Yes. Due to timing lags in the preparation and release of CalPERS Actuarial Valuation Reports, the UAL amount of $91.5 million is projected as of June 30, 2021 based on the City's June 30, 2019 Valuation Reports. Therefore, it does not include a factor for the most recent fiscal year ending June 30, 2020, when CalPERS earned 4.7% instead of the expected rate of return of 7%. The Actuarial Valuation Reports the City will receive in July 2021, will be "as of June 30, 2020", and will indicate a higher projected June 30, 2021 UAL due to the lower investment return. The determination of the new UAL requires complex actuarial calculations based on a set of actuarial assumptions, which can be divided into two categories:

- Demographic assumptions (e.g. mortality rates, retirement rates, disability rates, etc.)
- Economic assumptions (e.g. future investment earnings, inflation, salary growth rates, etc.)

How much will the City pay in interest on the UAL debt to CalPERS?

On the projected current UAL of $91.5 million, the City expects to pay $164.9 million from FY 2021-2022 through FY 2025-2046. Total interest is $164.9 million less the $91.5 million = 73.5 million.

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Assuming the City issued POB's at an all-in interest cost of 3.1%, how much would the City pay in interest over the life of the bonds?

On the current debt of $91.5 million, the City's estimated interest costs are $38 million, thus saving the City approximately $35.5 ($73.5 million -$38 million) million over 25 years. Present value savings are $31.7 million. Please refer to Power Point chart from the October 10, 2020 City Council meeting titled "Illustrative Pension Obligation Bonds – 100%"

What if City does not issue bonds and pays annual amortization amounts to PERS?

The City will forego interest savings as indicated above. The cash flow comparison shows the current method of payments to CalPERS will ramp up on the amortization payments over the next 11 years compared with level debt payments. The ramp up in payments will go from $5.7 million in fiscal year 2021 to over $10 million in fiscal year 2032. With no General Fund relief from issuing POBs there will be additional stress on the General Fund for the next 11 years.

What if PERS earns less than 7.00% in the future?

The 7.00% PERS discount rate used in these calculations is based on assumptions made PERS. Staff realizes that future events are subject to uncertainty, but these assumptions are made by professionals and our decisions are based on information provided by CalPERS. We can expect some variability in earnings, one year may be 6.8%, next year 7.5%, but in the long run, the return is expected to be 7.00%. With variability in returns, we can expect increases and decreases in UAL. However, the proposed City pension policy provides for set aside of savings in case UAL is trending upward, and for additional discretionary payments to more quickly amortize any future UAL.

If POB bonds are approved by City Council when will bonds be issued?

The Pension Obligation Bonds would be issued in the spring of 2021. Once the Resolution and Indenture are approved by City Council it takes approximately 20 months for the completion of the process

Is it important to have a Pension Policy as best practice? What do other Cities do?

Rating agencies have highlighted as a credit positive the approval of a Pension Policy. KNN, the City's municipal advisor, has advised all of our cities who have issued or are considering issuing POBs to adopt a pension policy consistent with the form that Manhattan Beach is considering.