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CITY OF OAKLAND

MEMORANDUM

TO: CITY COUNCIL

FROM: Mayor Jean Quan
City Administrator Deanna Santana

SUBJECT: PFRS Pension Obligation Bonds

DATE: May 21, 2012

INFORMATION

The purpose of this informational report is to provide the City Council with information to respond to recent questions on why it is in the best interest of the City to issue Pension Obligation Bonds ("POB's") to finance the City's contributions for the City's closed Police and Fire Retirement System ("PFRS") and answer the question "***Why issue POBs and what is the benefit?"***

The City cannot afford to continue funding PFRS on a pay as you go basis without a long-term strategy and without putting financial measures in place to help mitigate risk. For the past few years the Council has acknowledged that the PFRS funding levels are inadequate and have been exploring options to mitigate the impact to the City. There are insufficient funds to pay annual PFRS obligations in the short term, which would result in significant general fund shortfalls (over $29 million in 2012-13), requiring drastic cuts in service to the community. We need a long-term strategy with responsible fiscal measures. Implementing staff's long-term strategy would bridge the gap by matching available revenue resources to the obligations, bringing the City through otherwise very tough budget challenges.

We are recommending a fiscally responsible, long-term funding approach to fund the City's Police and Fire Retirement System. The recommendation seeks the City Council's approval of the following; (1) authorization to issue and sell pension obligation bonds (POBs) for the purpose of pre-funding the City of Oakland's Police and Fire Retirement System (PFRS) over the next five years (which reduces the overall cost/debt), (2) establishing a reserve of no less than $25 million from the existing balance in the tax override fund for the purpose of funding PFRS in the event of predetermined risks, (3) developing predetermined triggers for possible additional City action to mitigate market and funding risk, and (4) designating, for the sole purpose to fund PFRS, if needed, from resources that will become available beginning in FY 2015-16 due to declining general fund and tax override fund debt service payments due to retiring debt (debt that will be paid off).

History of PFRS Problems
The challenges facing PFRS are not new nor have they developed in recent years, but over a long period of time. The long-term strategy we support as outlined in the staff report to the May 22nd Finance Committee is a plan to mitigate some of the challenges we have been facing and to mitigate the risk to the General Fund.

Following is a detailed analysis on why the City should issue pension obligation bonds and approve a long-term funding strategy, and how it is in the City's best interest to do so.

Mitigating Budget Impacts to General Fund
If the City did not issue POB's, funding would be required from the City's general fund, ranging from$13 million to $29 million per year, beginning in fiscal year 2012-13. Since the last "suspension period" ended in July 2011 as a result of the previous prefunding to PFRS, the City has paid the System approximately $3.8 million per month. These funds have accumulated in the tax override fund from tax override and annuity revenues in past years. However, it should be noted that the current balance in the tax override fund is decreasing since the City's annual contributions to PFRS combined with the existing annual debt obligations for PFRS is greater than the dedicated annual revenues the City receives (tax override revenues and annuity proceeds). Any shortfall would require funding to be paid from the general fund. Absent issuing the proposed 2012 POBs, as presented in a staff report to the Finance and Management Committee on May 8, 2012, the general fund support required for fiscal year ended June 30, 2013 would be approximately $29.6 million. Similar general fund requirements would be needed in future years as well, ranging from $13 million to $29 million per year between FY 2013-14 to FY 2022-23, totaling almost $235 million from the general fund. Therefore, issuing the POBs to finance the contribution to PFRS will mitigate risk to the City's general fund, alleviating the general fund support for a period of five years at a time in which the City has been faced with multiple year deficits and the fiscal impact of the dissolution of its Redevelopment Agency. By implementing a long-term strategy, as described below, and issuing the POB's, the City would bridge this funding gap for in the next several years and avoid the extreme measures that would otherwise be required to fund this obligation from the General Fund.

Long-Term Responsible Funding Solution – Designate and Commit PFRS Funding
It should be noted that we do not view this plan as short sighted, and we do Not suggest that we "kick the can down the road." On the contrary, instead, we are recommending a responsible long-term funding solution by securitizing available tax override funds to facilitate a POB issue in 2012 supported by the tax override revenues, thus allowing a prepayment into the system in which annual contributions would be suspended for five years. During the suspension period, the annual payments on the 2012 POBs debt service would be lower than the annual required PFRS contributions that the City would otherwise be required to pay to fund PFRS.

We are also supporting a long term funding strategy that aligns the City's funding of PFRS at times when the general fund and the tax override fund will be in a better position to support the PFRS obligations. Beginning in FY 2015-16 general fund related debt will mature (i.e., Convention Center and Master Leases). In addition, one of the PFRS POB related debt obligations will mature in 2017-18 (i.e., 2008 JPFA Refunding Bonds). As a result, the City will realize a total annual savings of approximately $35.5 million from these debt maturities (2015 to 2018). Therefore, after the prepayment period ends for this POB, either the annual ARC payments can resume or the City can explore other options when the City can support additional general fund contributions due to the declining debt service starting no earlier than FY 2015-16. We are recommending that the Council designate and commit these funds, at the time they become available, for the sole purpose to fund PFRS.

An additional funding aspect that is important to note is that the City can access the tax override revenue that will become unencumbered from 2024 to 2026 to secure additional bonding. The new pension bond will be paid by the tax override revenues which are pledged to PFRS obligation though 2026. We are not recommending an extension of the deadline of PFRS pension debt; staff has developed a bond structure that spreads the tax override revenues over the remaining years until 2026.

Establishing a Reserve to Mitigate Market Risk
We also recommend the establishment of a reserve of approximately $25 million to be funded from the current balance of the tax override fund for the purpose of mitigating market risk to the PFRS funds from the deposit of the POB proceeds and/or if the funding ratio reaches a level below a predetermined benchmark during the suspension period. In addition, we recommend that any excess tax override funds received during any given year above the Proposition XIII 2% property tax growth rate (after all other debt obligations are satisfied) be deposited into the reserve of the tax override fund. The purpose of this reserve is to set aside funds that could become available to fund PFRS as a mitigation of market risk and funding ratio risk. A predetermined benchmark level would be established that would be monitored during the duration of the suspension period.

Lower Cost of Debt
Issuing POBs at this time would be beneficial to the City given the current historical low interest rate environment. Based on the current market trends, the POB's would be issued at an estimated rate of interest of approximately 4.75%. Therefore, issuing POB's in the current market is the cheapest way to finance a portion of the City's PFRS obligation, while mitigating an immediate impact on the City's General Fund as the City addresses the PFRS obligation as a responsible long-term funding strategy.

Increase the Funding Ratio of the PFRS System
PFRS is currently severely underfunded at 37.5%, and requires annual contributions of $38.5 million in FY 2012-13. The recommended POB would bring the funding ratio up to 68.3% according to the PFRS Actuary.

The City previously issued pension obligation bonds in February 1997 in which the bond proceeds were deposited into the PFRS system to prefund the annual contributions through June 2011. Since July 2011 the City has been making monthly payments of approximately $3.8 million on a pay-as-you-go method for FY 2011-12 from the excess tax override revenues. Based on the current balance in the tax override fund, the City can only use the excess tax override revenues to offset these monthly payments for only a short period of time. It would not be in the City's best interest to deplete these revenues for pay-as-you go payments. Instead, as discussed below, we are recommending using most of the available remaining balance to establish a reserve. Furthermore, as the plan assets, currently valued at $256.4 million, continues to be depleted, without an infusion of cash to strengthen the funding level, annual costs would increase, putting additional pressure on potential funding support by the General Fund.

Market Risk

The primary potential risk associated with a POB program is investment risk in which investment returns need to meet or exceed the interest rate paid on the bonds for the life that the POB debt is outstanding. A primary factor that plays into the investment returns is market volatility, the market upturns and downturns can affect the ultimate financial gains and losses of issuing POBs. Therefore, POBs can only be viewed as a success or failure once the bonds are retired, not over a short-term period. Other associated risks involved in issuing pension obligation bonds which must be taken into consideration are:

- Actuarial assumptions that are not realistic or incorrect can result in increases in future contributions to the System.
- Future decline in Assessed Values of property within the City which could cause the primary funding source, Tax Override Revenues, to decline.
- Further benefit increases which would cause the projected liabilities to increase.

It should be noted that the Board recently adjusted some actuarial assumptions to reflect actual historical trends. Some of the changes resulted in an increase to the unfunded actuarial liability while other changes resulted in a positive impact by lowering the liability.

While past performance of the System's investment returns cannot reflect how future investment returns will perform, according to PCA, PFRS independent investment advisor, PFRS' portfolio has outperformed its policy benchmark over extended time periods through the oversight of the Board, its investment managers, investment advisors and City staff that provide oversight and support of PFRS.

Summary

Finally, after evaluating all available options to fund the PFRS system, by issuing the 2012 POBs to fund PFRS for the next five years, implementing the long-term strategy outlined above and putting the other measures noted above in place, the City would be in a much stronger long-term financial position. We support this strategy as the best option for the City as it improves the funded ratio of the PFRS, mitigates risk to the general fund (averting otherwise significant cuts in service to the community) and stabilizes the long-term funding of the System for the benefit of PFRS' beneficiaries.

Respectfully submitted,

/s/
JEAN QUAN
Mayor

/s/
DEANNA J. SANTANA
City Administrator

For questions please contact Scott P. Johnson, Assistant City Administrator, at (510) 238-6906.