NCIL AGENDA MATERIAL 4.5
DATE 1-11-94 ITEM NO.

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**OFFICE OF THE CITY TREASURER**

THOMAS P. FRIERY
TREASURER

# CITY OF SACRAMENTO

CALIFORNIA

January 7, 1994
F00900TF.MWW

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APPROVED
BY THE CITY COUNCIL

JAN 1 1 1994

OFFICE OF THE
CITY CLERK

City Council
Sacramento, California

Honorable Members in Session:

<u>SUBJECT</u>: PENSION OBLIGATION BONDS

<u>LOCATION AND COUNCIL DISTRICT</u>: Citywide.

<u>RECOMMENDATION</u>: This report recommends that City Council

1. Approve a Pension Obligation Bond financing, and

2. Authorize the City Treasurer to initiate the financing action plan shown as Attachment 1 of this report to accomplish a Pension Obligation Bond financing currently estimated to create $11.2 million in present-value savings and approximately $2.7 million annual cash flow savings over the next five years, and

3. Direct the City Treasurer to coordinate with the City Attorney to assure that a validation action is filed in Superior Court by January 18, 1994 in conjunction with the financing plan.

<u>CONTACT</u>: Lydia Lara, Deputy City Treasurer/Financing (916) 264-5168

<u>FOR COUNCIL MEETING OF</u>: January 11, 1994

## SUMMARY

This report advises City Council that it is both cost-beneficial and advantageous to borrow money in the "taxable" bond market and use the proceeds to pay off the City's unfunded liability for City employees who are members of the California Public Employee Retirement System ("PERS"). As of June 30, 1992, the City's unfunded liability for the affected employees was $65,665,455.

Currently the City makes monthly payments to PERS for both the unfunded liability portion and the City's normal payment to fund employee pension obligations. Primarily as a result of the PERS plan's 8.75% actuarial earning rate which the City incurs in calculating the City's unfunded liability and the fact that presently the City could borrow monies at approximately 7.28% (as of January 4, 1994), real cash savings will inure to the City if the obligation were to be paid off in its entirety. As a result, future payments would be made to pay off the bonds instead of PERS; those payments would be approximately $2.7 million less per year for the next five years as compared to fiscal year 1993. The present value savings are currently estimated at $11.2 million.

Presently the ratio of General Fund to Enterprise Fund payroll for City employees in the PERS plan is 98% to 2%. Therefore, the present value and cash flow savings described herein will be approximately split as follows:

- General Fund - cash flow savings $2.6 million, present value savings $10.9 million;
- Enterprise Funds - cash flow savings $.1 million, present value savings $.3 million.

Two critical variables could impact the financing and the amount of savings:

1. The City must perform a timely and successful validation action which is designed to show that the Pension Obligation Bonds are not debt (primarily because they are substituted for payments that the City otherwise must make), and

2. Taxable interest rates cannot increase above the current estimated level of approximately 7.2%. (Should interest rates vary ½% of 1% from current levels, present value savings will be impacted $3.6 million and cash flow savings will be impacted $944,553.)

Because of the unusual opportunity to borrow money at rates lower than the actuarial earning assumption used by PERS, combined with the possibility that interest rates may rise over the next several months, it is necessary to proceed in an expeditious manner.

## BACKGROUND INFORMATION

The City Treasurer discussed the concept of the use of Pension Obligation Bonds with the City's underwriting firm, Grigsby Brandford, in November 1993. Subsequent to this discussion, research has been underway to evaluate this technique for the City's PERS plan. In addition, one California county has recently issued such obligations and presently several California cities and counties are anticipated to bring issues to market in the next several months.

The City of Sacramento has been contracting with Public Employee Retirement System ("PERS") since January 29, 1977. The City is required to contribute to fund PERS, using the actuarial basis specified by the plan. PERS currently uses 8.75% interest as the actuarial earning assumption for the City's plan. By structuring the taxable pension bond to fully pre-pay existing unfunded obligation, it may be possible to create $11.2 million in present value savings and $2.7 million in cash savings per year over the next 5 years (Attachment 2). Standard assumptions in the bond financing are market interest rates at January 4, 1994, and conservative estimates of the costs of issuance. This preliminary view of the financing is based on a true interest rate estimate of 7.28% which will not be known until we can actually go to the market.

Actuarial unfunded liability is the amount of money a pension plan is deficient at a given point in time to pay the retirement benefits agreed to be paid to all plan members. The amount considers a myriad of actuarial considerations such as future salary increases, inflation, earnings on existing retirement fund balances and future contributions by the employer and employees as well as when employees will retire, mortality tables, and employees leaving the plan. Finally, the amount is a present-value amount and it is discounted by the future earnings on this amount at the actuarial earning assumption rate of the plan.

Actuarial unfunded liability is created through three basic events:

1. Plan members are provided enhanced retirement benefits which are approved by the employer, but for which the employee and employer previously did not provide funding, and/or
2. Actual experience of plan participants is different than actuarial earning assumptions, i.e. inflation or employer wage increases are greater than estimates, investment earnings are less than estimated, greater disability or early retirements than projected, etc., and/or
3. A miscalculation is made in the assessment of the ability of the fund and future contributions to provide the agreed retirement benefits.

PERS recognizes that, for actuarial purposes, it does not need full payment of the unfunded liability created by the above conditions and therefore allows cities to "finance" these charges over time. The City amortizes its payments for safety members and miscellaneous members over a predetermined period based on a percentage of current employee payroll.

As noted above the City of Sacramento has a current unfunded liability with PERS of approximately $65.7 million, $62.4 million for safety employees and $3.3 million for miscellaneous employees. Through contractual arrangements with PERS, the City makes monthly payments to PERS composed of two parts. The regular contribution portion is to support the ongoing obligations of its employees as service is accrued. The other portion of the contribution is to pay for the City's unfunded accrued liability.

Following discussions with the City's lead underwriter, it appears that the City could issue Pension Obligation Bonds to pay off the PERS loan at a true interest rate of 7.28%. The estimated debt service savings are projected to range from $1.1 million to $2.7 million annually. This is equivalent to approximately $10.9 million to $11.2 million in present value savings.

FINANCIAL CONSIDERATIONS

The following table highlights four possible scenarios for the issuance of the Pension Obligation Bonds. The first column identifies financing structures that envision receiving cash flow savings equally over the life of the bond issue whereas the second column envisions loading cash flow savings over the next 5 years. Also, the top section describes a structure where the bonds issued are callable, whereas the bottom section describes a non-callable bond structure.

Table of Financing Alternatives
(000's omitted)

| | Callable Bond Structure[1] | |
|---|---|---|
| | Level | 5-Year Loaded |
| True Interest Cost | 7.27% | 7.31% |
| Average Life | 15.3 years | 16.5 years |
| Average Annual Cash Flow Savings | $ 1.1 | $ .734 |
| 5-Year Actual Cash Flow Savings | $ 1.1 | $ 2.7 |
| Present Value Savings | $11.3 | $10.9 |
| | **Non-Callable Bond Structure** | |
| | Level | 5-Year Loaded |
| True Interest Cost | 7.23% | 7.28% |
| Average Life | 15.3 years | 16.5 years |
| Average Annual Cash Flow Savings | $ 1.2 | $ .763 |
| 5-Year Actual Cash Flow Savings | $ 1.2 | $ 2.7 |
| Present Value Savings | $11.6 | $11.2 |

At the present time we estimate that 98% of these savings will inure to the City General Fund and 2% to other City Enterprise Funds. It is pointed out that for each ½ of 1% change in interest rates between today's rates and actual rates, present value savings will change approximately $3.6 million and cash flow savings will change $944,553 million under the front loaded option.

The proposed entry into the taxable bond market represents the City's first attempt to sell taxable bonds. The Treasurer believes the City's credit will be successfully accepted by investors who will view the solid credit and financial condition of the City. Although tax-free rates are approximately 25% less than taxable rates, federal tax laws on arbitrage prohibit a City from borrowing money tax-free and then putting the proceeds into taxable investments as PERS will do when the City makes their payment.

[1] $30 million of the capital appreciation bonds are not callable. Of the entire issue, only 22% are actually callable. There is a call protection which restricts the call feature for the first 10 years.

Based on current market conditions, the City Treasurer would recommend the financing structure using non-callable term bonds and loading cash flow savings in the next 5 fiscal years. The fiscal impact of this structure would be a potential cash flow savings of approximately $2.7 million annually over the next 5 ¼ years and present value savings of $11.2 million. However, if market conditions should change, a structure using callable bonds might be used if the benefits are greater.

POLICY CONSIDERATIONS

- Should the City issue Pension Obligation Bonds to finance the actuarial unfunded liability?

  Since the unfunded liability is computed using a scientific approach to project a series of assumptions, it is possible that the actuarial unfunded liability (which is an actuarial estimate) could prove to be less than presently estimated. However, it is highly improbable that a reduction in the current actuarial unfunded liability would arise unless the retirement benefits currently contracted to be paid to employees are reduced, or unless there were to be a major termination of the younger average-age employees in the City's work force and they were dismissed and withdrew their retirement deposits. Based on information currently available these occurences do not appear to be either reasonable or probable.

- Should the City fund all of the actuarial unfunded liability or only a portion thereof?

  It is possible that (1) the current actuarial unfunded liability estimate will, at a future date, be less than the esimate because actual experience of the plan and participants is more favorable than actuarial projections, or (2) that changes may be made in future actuarial assumptions. In discussion with the City's actuary, the assumptions used by PERS' actuaries for this plan are reasonable. Further, given the interrelatedness of all the various actuarial assumptions, a change in one may require an off-setting change in another. Therefore,for example, although it is possible that a change might be made reducing PERS' estimates of future wage growth, it should also be considered that a corresponding reduction would also be made to reduce the actuarial earning assumption. Based on information currently available, it does not appear that any appreciable reduction will occur in unfunded liability estimates for the City's PERS plan even though it is possible that changes might be made to certain of the assumptions.

- Should the present-value savings be received over the life of the financing instrument, or should they be weighted to occur over a shorter period, i.e. 5 years?

  Five years would be the shortest time period over which cash flow savings could be received based on the 16.5 average year life of the Pension Obligation Bond financing structure. A financing structure providing cash flow savings over a 5 year period maximizes the cash flow savings possible and provides almost a three-to-one cash flow savings advantage compared to a structure realizing the annual cash flow savings equally over the 16.5 year life of the Pension Obligation Bond financing structure. The City Treasurer believes it is prudent to capture the savings in a 5-year period even though the average life of the bond structure is 16.5 years. In contrast, if the savings are received in equal annual amounts over a 16.5 year period, cash flow savings would be reduced in each year over the next 5 years from the projections contained in this report since approximately only $1.1 million in annual cash flow savings would be received.

MBE/WBE

MBE/WBE firms have at least 32.5% participation in City financings.

Respectfully submitted,

Thomas Friery
City Treasurer

Attachments

Recommendation Approved:

William Edgar, City Manager

Attachment 1

# City of Sacramento
# Pension Obligation Bonds, Series 1994

## ACTION PLAN

| *Date* | *Activity* | *Participants* |
|---|---|---|
| 1/11/94 Tuesday | City Council Meeting to approve financing concept and allow for Validation Filing | City |
| 1/18/94 Tuesday | File Validation | City, CA, BC |
| 1/21/94 Friday | First Draft of Legal Documents | BC |
| 1/26/94 Wednesday | First Draft of Preliminary Official Statement | UC |
| 1/28/94 Friday | Working Group Meeting for document review | All |
| 2/5/94 Friday | Second Draft of Legal Documents and POS | BC, UC |
| 2/12/94 Friday | Financing Package sent to Rating Agencies and potential Bond Insurers | UW |
| 2/24&25/94 Thurs. & Friday | Rating Agency & Bond Insurance Presentations | City, UW, BC |
| 3/8/94 Tuesday | Default Judgement Awarded on Validation Suit | City, CA, BC |
| 3/15/94 Tuesday | City Council meeting to approve and authorize financing and upcoming sale | City |
| 3/16/94 Wednesday | Preliminary Official Statement to Printer | UW, UC |
| 3/17/94 Thursday | Mail and Distribution of POS<br>Receive Ratings and/or Bond Insurance Bids | UW, UC<br>UW, City |
| 3/29/94 Tuesday | Pricing of Taxable Pension Obligation Bonds | UW, City |
| 4/1/94 Friday | Final Official Statement to Printer | UW, UC |
| 4/12/94 Tuesday | Pre-Closing | All |
| 4/13/94 Wednesday | Closing | All |

**Legend**
City = City Treasurer's Office and all required City personnel
CA = City Attorney's Office
BC = Bond Counsel (Orrick, Herrington & Sutcliffe)
UW = Underwriters (Grigsby Brandford, DLJ, Stone & Youngberg, Merrill Lynch)
UC = Underwriters Counsel (Ochoa & Sillas)

Attachment 2

The City of Sacramento
Taxable Pension Obligation Bonds, Series A
"Assumes Non-Callable 2016 Term Bond" (8 basis point gain)
"Market as of January 3, 1994"
DEBT SERVICE COMPARISON FROM 4/01/1994

| DATE | PRINCIPAL | INTEREST | NEW NET D/S | PRIOR NET D/S | SAVINGS |
|---|---|---|---|---|---|
| 7/01/1994 | - | 738,875.00 | 738,875.00 | 1,188,404.00 | 449,529.00 |
| 7/01/1995 | - | 2,955,500.00 | 2,955,500.00 | 5,003,178.00 | 2,047,678.00 |
| 7/01/1996 | - | 2,955,500.00 | 2,955,500.00 | 5,265,845.00 | 2,310,345.00 |
| 7/01/1997 | - | 2,955,500.00 | 2,955,500.00 | 5,542,302.00 | 2,586,802.00 |
| 7/01/1998 | - | 2,955,500.00 | 2,955,500.00 | 5,833,273.00 | 2,877,773.00 |
| 7/01/1999 | - | 2,955,500.00 | 2,955,500.00 | 6,139,520.00 | 3,184,020.00 |
| 7/01/2000 | 3,355,000.00 | 2,955,500.00 | 6,310,500.00 | 6,461,874.50 | 151,374.50 |
| 7/01/2001 | 3,150,000.00 | 2,749,167.50 | 5,899,167.50 | 6,047,848.00 | 148,680.50 |
| 7/01/2002 | 3,665,000.00 | 2,549,142.50 | 6,214,142.50 | 6,365,360.00 | 151,217.50 |
| 7/01/2003 | 2,263,184.00 | 4,284,566.00 | 6,547,750.00 | 6,699,542.00 | 151,792.00 |
| 7/01/2004 | 2,280,908.70 | 4,621,841.30 | 6,902,750.00 | 7,051,268.00 | 148,518.00 |
| 7/01/2005 | 2,289,784.00 | 4,982,966.00 | 7,272,750.00 | 7,421,459.00 | 148,709.00 |
| 7/01/2006 | 2,290,065.25 | 5,367,684.75 | 7,657,750.00 | 7,811,086.00 | 153,336.00 |
| 7/01/2007 | 2,286,231.30 | 5,781,518.70 | 8,067,750.00 | 8,221,168.00 | 153,418.00 |
| 7/01/2008 | 2,277,796.20 | 6,224,953.80 | 8,502,750.00 | 8,652,779.00 | 150,029.00 |
| 7/01/2009 | 2,225,263.80 | 6,728,811.43 | 8,954,075.23 | 9,107,050.00 | 152,974.77 |
| 7/01/2010 | 2,220,585.60 | 7,212,164.40 | 9,432,750.00 | 9,585,170.00 | 152,420.00 |
| 7/01/2011 | 2,141,162.25 | 7,796,811.33 | 9,937,973.58 | 10,088,392.00 | 150,418.42 |
| 7/01/2012 | 2,126,621.25 | 8,338,240.78 | 10,464,862.03 | 10,618,032.00 | 153,169.97 |
| 7/01/2013 | 2,110,868.50 | 8,911,881.50 | 11,022,750.00 | 11,175,479.00 | 152,729.00 |
| 7/01/2014 | 9,300,000.00 | 2,312,750.00 | 11,612,750.00 | 11,762,191.00 | 149,441.00 |
| 7/01/2015 | 10,590,000.00 | 1,638,500.00 | 12,228,500.00 | 12,379,707.00 | 151,207.00 |
| 7/01/2016 | 12,010,000.00 | 870,725.00 | 12,880,725.00 | 13,029,641.00 | 148,916.00 |
| TOTAL | 66,582,470.85 | 98,843,599.99 | 165,426,070.84 | 181,450,568.50 | 16,024,497.66 |

Grigsby Brandford & Co., Inc.
Investment Bankers

FILE = SAC1039C
1/ 4/1994 12:52 PM

| | |
|---|---|
| GROSS PRESENT VALUE DEBT SERVICE SAVINGS | $11,174,361.22 |
| Other Benefits.................................... | - |
| Deposit to Debt Service Fund...................... | - |
| Amount released from Prior Issue DSR Funds........ | - |
| Other Costs....................................... | - |
| Cash Contribution................................. | - |
| Transfers from Prior Issue Debt Service Fund...... | - |
| NET PRESENT VALUE BENEFIT | $11,174,361.22 |
| Savings as a % of refunded bond principal amount.. | 17.0171077% |

APPROVED
BY THE CITY COUNCIL

JAN 11 1994

OFFICE OF THE
CITY CLERK

# RESOLUTION NO. 94-030

ADOPTED BY THE SACRAMENTO CITY COUNCIL

ON DATE OF ____________________

RESOLUTION AUTHORIZING THE CITY TREASURER TO PROCEED WITH THE ISSUANCE OF PENSION OBLIGATION BONDS TO FINANCE THE ACTUARIAL UNFUNDED LIABILITY FOR CITY EMPLOYEES WHO ARE MEMBERS OF THE CALIFORNIA PUBLIC EMPLOYEES RETIREMENT SYSTEM.

WHEREAS, the City Treasurer has presented a financing plan to finance the California Public Employees Actuarial Unfunded Obligation of $65.7, and

WHEREAS, the City Council has reviewed the City Treasurer's financing plan and determined that the City may experience significant savings as a result of financing the unfunded liability, and

WHEREAS, the City Council has determined that it is reasonable to incur certain non-reimbursable costs in light of the anticipated present-value savings of approximately $11.2 and annual cash savings in the range of $1.1 million to $2.7 million based on the January 4, 1994 market rate of 7.28%

NOW, THEREFORE, BE IT RESOLVED by the City Council of the City of Sacramento as follows:

1. The City Council approves the financing plan and related costs to finance the Public Employees Retirement Actuarial Unfunded pension liability.

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**FOR CITY CLERK USE ONLY**

RESOLUTION NO.: ____________

DATE ADOPTED: ____________

2. The City Council authorizes the City Treasurer, with approval of the City Manager and subsequent reporting to the City Council, to incur certain non-reimbursable costs related to the financing which, in the event the financing does not occur, shall be borne proportionally by the funds which were anticipated to have experienced savings by the proposed financing.

This Resolution shall take effect immediately upon its passage.

_____________________________

Mayor

[SEAL]

ATTEST:

_________________________

City Clerk

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**FOR CITY CLERK USE ONLY**

RESOLUTION NO.: ________________

DATE ADOPTED: ________________