PENSION REFORM COMMITTEE
MEETING OF
Tuesday, January 6, 2004
4:00 PM – 6:00 PM Meeting

401 B Street
Conference Room, 4th Floor

MINUTES

THE REGULAR MEETINGS OF THE PENSION REFORM COMMITTEE ARE SCHEDULED FOR EVERY TUESDAY AT 4:00 PM AT 401 B STREET, 4TH FLOOR

Item 1: Call to Order

The meeting was called to order at 4:05 PM.

Item 2: Roll Call

Members Present	Members Absent	Staff Present
April Boling		Patricia Frazier
Steve Austin		Chris Morris
Robert Butterfield		Paul Barnett, SDCERS Staff
Tim Considine		Lori Chapin, SDCERS Staff
Judie Italiano		Pam Holmberg
William Sheffler		
Richard Vortmann		
Kathleen Walsh-Rotto		
Stanley Elmore		

Item 3: Approval of Minutes

There was a motion made by Mr. Vortmann for approval of the minutes of the December 9, 2003 Pension Reform Committee (Committee) meeting. The motion was seconded by Ms. Walsh-Rotto and it passed unanimously.

Item 4: Pension Obligation Bonds

Deputy City Manager Patricia Frazier asked Paul Barnett to update the Committee on the June 30, 2003 Actuarial Valuation Executive Summary. Mr. Barnett highlighted the key findings of the summary. Ms. Boling asked if the City's retirement contribution could be calculated from the report. Mr. Barnett indicated that the actuarial rate was provided in the summary and could be applied to the estimated payroll. However, the summary is a preliminary report. The final report from the actuary is expected at the January board meeting. Mr. Vortman asked if the

City's contribution under Manager's Plan II had been calculated. Mr. Barnett indicated that calculation will be made after the final report is received and will be provided to the Committee.

Deputy City Manager Patricia Frazier provided a presentation on Pension Obligation Bonds and answered questions from the Committee. Please see the attached presentation. Kathleen Walsh-Rotto asked for UAAL data for those jurisdictions which had issued Pension Obligations Bonds

Item 5: Work Plan for the Pension Reform Committee

Ms. Boling asked if the City would be able to provide information comparing the compensation package offered by the City with those of other public entities and the private sector. Cathy Lexin, the City's Human Resources Manager, responded that the City has data comparing the compensation offered by the City with the County, the Cities within the County, and the ten largest Cities within California. The data compares the compensation offered to Safety Classifications (Police Officers and Firefighters), since those classes make up over half of the City's payroll. The information was to be presented to the Committee on December 16 by Bruce Herring, but his presentation was canceled and has not been rescheduled. Ms. Lexin did not have specific comparisons with the private sector but could provide salary information from the Bureau of Labor website comparing various job types. She said a comparison with the private sector could be very difficult since many jobs in the public sector are only done in the public sector. Ms. Boling said the Committee needs to see some kind of comparison to prove or dispel the idea that employees in the public sector earn lower salaries than in the private sector and should be compensated with larger benefit packages. The Committee requested a presentation on the comparative compensation data.

Item 6: Comments by Committee Chairperson

Ms. Boling reported that she attended the last meeting of the Retirement Board. She asked the Board and Mercer, the auditor performing the three audits for the Board, if it would be possible to certify the CERS actuary, Rick Roeder, and Callan Associates, the CERS investment advisor, on an accelerated schedule. She hoped to get the certification within the first four to six weeks of the audits. The Board and Mercer were agreeable and said she should have the requested information by February 15.

Item 7: Comments by Committee Members

Steve Austin requested that some sort of a matrix be created and added to each meetings minutes showing assignments from the Committee, who is responsible for the assignment, and when it is completed.

Mr. Considine reported he spoke with Stanford Bernstein about the possibility of them providing a pro bono analysis of the CERS investment performance. They are willing to do so. The Committee asked Mr. Considine to draft the scope of work to review the asset allocation and investment performance.

Mr. Butterfield asked if a meeting was planned where the public could give input on the Retirement process without the constraint of the three minute time limit of non-agenda speakers. Ms. Boling said the Committee wasn't planning on having such a meeting but had invited the public to submit any input in writing. If the Committee has questions on the written comments they will invite the person to become a speaker. However, if Mr. Butterfield would like to develop a specific proposal for the Committee's consideration, it can be discussed at the next Committee meeting.

Item 8: Non-Agenda Public Comment

Jim Gleason submitted a speaker's slip but indicated his concerns were addressed in the Pension Obligation Bond presentation.

David Crow is a City retiree who, for the past five years, has served as the elected retired representative to the Retirement Board. He wanted the Committee to know that not all retirees shared the views expressed to the Committee by other retirees. Many retirees felt that it wasn't necessary to bring a lawsuit against the City and the Retirement system. Although there is no legal basis to require the City to provide enhanced benefits, they have worked with the retirees in the past to provide several enhancements. At present time, the retirees receive all of their vested defined benefits and will continue to receive them. The only benefits they have not received are contingent benefits that were made contingent when they were established. The recent losses in the stock market caused the situation which didn't allow for the payment of those benefits. He wanted to assure the Committee that the City and the Retirement Board are made aware of the needs of the City's retirees. He is confident that as the retirement system recovers for the years of poor stock market performance all retirees will receive both their defined and contingent benefits.

Nancy Acevedo, the president of the City of San Diego Retired Employee Association, said that her Association had distributed three issue papers on items of concerns of retirees to the Retirement office to review. They were regarding health insurance, the supplemental COLA, and annual supplemental benefit (the thirteenth check). The only response they have received is on the annual supplemental benefit. She distributed copies of the issue paper on the annual supplemental benefit to the Committee. She said last year when it was made public that the thirteenth check would not be paid, and anonymous donor gave $100,000 to be distributed to the most deserving retirees. Those checks were distributed at the end of November to 186 recipients who received an average of $540 each. The amount of their monthly benefit ranged from $63 a month to $369 a month. It is these retirees that her association is concerned about.

Item 9: Adjournment

The meeting was adjourned at 5:55 PM.

The next meeting will be on Tuesday, January 13 at 4:00 PM at the same location.

Pension Obligation Bonds (POBs)

Presentation to

Pension Reform Commission

January 6, 2004

Pension Obligation Bonds (POBs)

- **What are POBs?**

- POBs are taxable bonds issued by the Plan Sponsor (the City) to finance all or part of an existing UAAL

- **Why issue POBs?**

- ***Interest rate savings*** – Primary reason for issuing POBs is to lower interest costs. If rates on POBs are lower than the assumed actuarial cost on the outstanding UAAL there are interest rate savings

- ***Higher Funded Ratio*** – Replacing UAAL with POB issuance initially increases the Pension System's funded ratio

- ***Restructuring*** – POBs provide a tool to reshape and restructure the liability associated with the amortization of UAAL

Pension Obligation Bonds (POBs)

Why now?

❑***Historically Low Rates*** – Current low rates make POBs a more viable option for addressing issues related to under funding and high UAALs

Why not now?

❑***Reinvestment Rates*** – Current low rates need to be weighed against potential trend in rates for reinvestment of POB proceeds over the life of the bonds

Example: A number of the issuers of POBs in the early 1990's when interest rates were at very low levels have seen their UAALs reappear and funded ratios fall due to investment losses and, in some instances, benefit enhancements agreed to when funded ratios were at high levels.

Pension Obligation Bonds (POBs)

What is the legal basis for POBs?

❑In California, POBs are issued under the local agency refunding law

❑Under this law, refunding bonds may be issued to refund outstanding indebtedness imposed by law but cannot be used to meet plan sponsor's current year pension plan obligations

❑Since UAAL has been determined to be an obligation imposed by law, POBs may be issued to refund that obligation

❑However, due to the legal uncertainty and the fact that there has been at least one successful attack at trial court level in the State's proposed POBs, bond counsel would likely require a legal validation action prior to any POB issuance

Pension Obligation Bonds (POBs)

- ❑POBs are not subject to voter approval under a judicially created exception to the voter approval requirements of Article XVI, Section 18 of the State Constitution for “obligations imposed by law”

- ❑The structures of POBs do not fit any of the protocols for tax-exempt financings, hence they need to be issued on a taxable basis

- ❑POBs are generally priced at a spread to US Treasuries and the spread is subject to change depending upon market conditions

Pension Obligation Bonds (POBs)

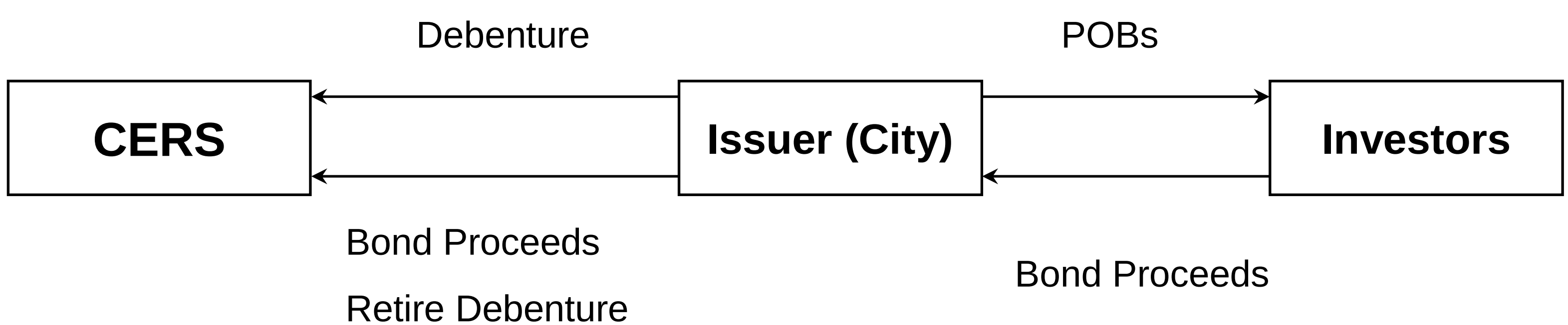
POB Structure

- The Pension Plan Sponsor (the City) issues a debenture to the Pension System equal to all, or a portion of the UAAL

- The debenture evidences the debt owed (a portion or the entire UAAL) by the Sponsor which is refunded with the POBs

- The Plan Sponsor (the City) issues POBs

- Proceeds of the Plan Sponsor's POB issuance are transferred to the System, which redeems the debenture



Pension Obligation Bonds (POBs)

- The taxable POBs market started in 1993 with Sonoma County's $97 million transaction. Since then, approximately $16 billion of POBs have been issued nationwide

- In California, examples of POB issuances in 2002/2003 are:

• Long Beach	$ 82 million
• Fresno County	$322 million
• Imperial County	$ 33 million
• San Diego County	$750 million
• Mendocino County	$100 million
• Contra Costa County	$400 million
• Sonoma County	$225 million
• Kern County	$250 million
• San Luis Obispo County	$ 60 million
• Sacramento County	$ 60 million

Pension Obligation Bonds (POBs)

Outcome after POBs are issued

❑UAAL, an internal legal obligation of the Plan Sponsor (the City), is replaced by an external debt obligation in the form of POBs and increases the City's long term debt load. The issuance of the POBs may not mitigate the overall cash flow requirements of the City for a composite of pension plan payments and debt service payments

❑Plan Sponsor is still liable for contributions related to annual normal costs (actuarially calculated contribution needed to cover present value of benefits allocated to the current year)

❑UAAL reduced through POBs may still reappear due to experience losses or benefit increases

❑Total pension related costs for the Plan Sponsor will include annual debt service on POBs over the life of the bonds plus annual pension contribution (normal costs) requirements

❑Pension System invests lump sum payment of POB proceeds according to the Pension System's portfolio management requirements

Pension Obligation Bonds (POBs)

Risks

❑***Reinvestment Risk*** – If the yield (return) on reinvestment of POB proceeds over the life of the bonds is less than the actuarially assumed rate there will be negative interest rate savings. This would have been the case if POBs had been issued during the year ended June 30, 2002 or 2003, and due to very adverse market conditions, and as a consequence of smoothing the actuarial losses may continue for the next 2 to 3 years.

> ***Example:*** Issuer sells POBs at 6.0% to reduce its UAAL that has been carrying an 8% assumed rate. The issuer is worse off if the System earns less than the POB rate of 6.0% over the life of the bonds.

Investment of lump sum prepayment – Need to invest large lump sum payment in the form of POB proceeds as opposed to steady contributions may create risks in terms of greater exposure to market fluctuations in the short-term

Pension Obligation Bonds (POBs)

Risks (Cont)

❑***Benefit Enhancements*** – Increase in funded ratio may prompt demands for benefit enhancements, putting additional strain on the system

❑***Flexibility*** – Since POBs replace a “soft” internal liability with a “hard” external debt obligation, there is less flexibility, in terms of funding pension costs

❑***Reappearance of UAAL*** – Reappearance of UAAL due to negative returns on System’s portfolio, other experience loss factors or benefit enhancements would be difficult to explain to policy makers

Pension Obligation Bonds (POBs)

Benefits

❑**Favorable interest earnings results in a positive arbitrage**

Example: Issuer sells POBs at 6.0% to reduce its UAAL that has been carrying an 8% assumed rate. The issuer benefits if the System earns more than the POB rate of 6.0% over the life of the bonds.

❑***Higher Funded Ratio*** – A POB issuance will initially result in a higher funded ratio with the retirement of all, or a portion of the UAAL

❑***Reduced Contribution levels –*** A POB issuance can, initially, result in reduced contribution levels from increased funded ratio/reduced UAAL due to lower UAAL amortization expenses. For the City, there will be one year lag to realize reduced contributions.

Pension Obligation Bonds (POBs)

EXAMPLE:

- POB Par Amount: $100 million
- Estimated Interest Rate (current taxable market): 6.05%
- Estimated Level Debt Service: $7 million
- Estimated Term 30 years

Pension Obligation Bonds (POBs)

ESTIMATED BREAKDOWN OF COSTS:

- Issue Size: $100 million
- Costs of Issuance (incl. underwriting fee): $750,000
- Credit Enhancement: $1.1 million
- Net Proceeds Available to transfer to Pension System: $98.1 million

Pension Obligation Bonds (POBs)

COMPARISON OF COST FACTORS

- The following table shows the difference in terms of cost elements between

Without POBs				**With POBs**		
Normal Costs	UAAL Costs	Total	Normal Costs	UAAL* Costs	Debt Service	Total

*A POB issuance for the full amount of the UAAL will initially eliminate the need to budget funds for UAAL amortization costs. However, if the UAAL reappears there would be a need to budget for these costs.

Pension Obligation Bonds (POBs)

Credit Implications

- Since POBs are an “absolute and unconditional obligation” of an issuer, but without the voter approval and taxing authority of a general obligation bond, and not subject to abatement as are lease obligations, Moody’s, in most instances, rates POBs one level below an issuer’s General Obligation rating

- The rating agencies view the funding of promised retirement benefits as one of a municipality’s highest priority

- According to Fitch Ratings, “a funded ratio at less than 60% is a cause for a significant rating concern”

- In recent local news articles, it was indicated that any funded ratio figure below 70% is potential grounds for rating agencies to downgrade bond ratings

- Overall, rating agencies factor the effects of a POB strategy into the long term rating of the Plan Sponsor. Standard & Poor’s views POBs as a strategy for savings on carrying UAAL as long as the POB transaction is structured conservatively and the assumptions are reasonable and attainable.

Pension Obligation Bonds (POBs)

Credit Implications (Cont)

- In evaluating POBs, the ratings agencies consider the potential for stress on the issuer's ability to meet debt service payments and other pension obligations

- Rating Agencies view POBs more favorably if they are not a stand alone response to a low funded ratio but part of a more comprehensive strategy to address structural funding issues while making steady progress toward full funding

- The components of a strategy to complement a POB issuance may include increasing contribution rates and/or reducing the growth in benefit costs

Pension Obligation Bonds (POBs)

Alternatives to POBs

- Constrain rate of growth in future benefits enhancements
- Modify funding policy to constrain growth in UAAL
- Identify special revenue source to contribute to funding of pension obligations

Pension Obligation Bonds (POBs)

Conclusions

- POB instrument is not a panacea. It has potential uses to certain Plan Sponsors and Pension Systems under certain market conditions
- Issuing POBs does not extinguish any debt. It transfers the UAAL of the Pension System to the balance sheet of the Plan Sponsor
- POBs recast a soft liability into on balance sheet debt (hard liability) and may strain debt capacity of the Plan Sponsor
- Pension expense equals POB debt service plus annual contributions to the Pension System
- Timing of the POB issuance is critical. POBs issued in 1994/1995, just as the market took off were timed right. POBs issued in 1999, just as the market headed down were not timed right
- POB issuance is a form of risk arbitrage. POBs can be successful only if the proceeds earn the Pension System’s assumed investment rate, and at a minimum, a return that will exceed the borrowing costs