City of Gainesville

Office of the City Auditor

Memorandum

To: The Honorable Mayor and City Commissioners

From: Ginger Bigbie, CPA, CFE, City Auditor

Date: August 20, 2020

Re: Credible Challenge of Management's Proposed October 1, 2020 Pension Obligation Bond Financing Plan as presented in, "City of Gainesville Retirement Plans – Pension Obligation Bond Analysis –PFM"

Purpose:

The City Manager is responsible for using reliable and balanced methodologies and assumptions when providing information for approval to the City Commission. During the August 6, 2020 City Commission meeting, Commissioners requested the City Auditor review management's pension obligation bonds (POB) financing plan, and provide a response at the August 20, 2020 City Commission meeting.

Internal Audit Objective: To provide credible challenge to management's POB financing plan after reviewing analyses provided to management by pension plan trustees and consultants.

Scope and Methodology: Our comments are limited to challenging management assumptions in the current POB financing plan and ensuring POB financing risks and benefits are adequately covered in the presentation to the City Commission. Our review is not considered an internal audit and does not include any audit procedures or other testing of pension plans or management controls.

We reviewed key elements of management's POB financing plan including the timing, expected annual rate of return, percentage of unfunded liability financed, amortization period, and Covid-19-related disclosure.

Timing:

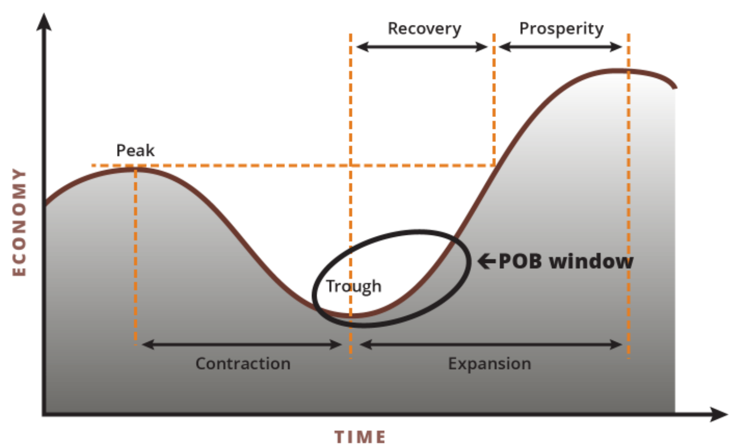
Management plans to finance the pension obligation bonds on 10/1/2020 to coincide with the start of the next fiscal year.

Credible Challenge: Is this the right time to for the City to undertake POB financing?

YES

The window of opportunity is still open to revisit this financing strategy, according to a recent article authored by Girard Miller. See Figure 1 below from, "*The Time is Ripe for Public Pension Obligation Bonds,"* Pensions&Investments, March 25, 2020.

FIGURE 1 The business cycle and the POB window



Source: https://www.pionline.com/industry-voices/commentary-time-ripe-public-pension-obligation-bonds

NO
Government Finance Officers Association (GFOA) Advisory: State and local governments should not issue POBs. This advisory, active for several years, states, "Pension obligation bonds (POBs) are taxable bonds that some state and local governments have issued as part of an overall strategy to fund the unfunded portion of their pension liabilities by creating debt. The use of POBs rests on the assumption that the bond proceeds, when invested with pension assets in higher-yielding asset classes, will be able to achieve a rate of return that is greater than the interest rate owed over the term of the bonds. However, POBs involve considerable investment risk, making this goal very speculative. Failing to achieve the targeted rate of return burdens the issuer with both the debt service requirements of the taxable bonds and the unfunded pension liabilities that remain unmet because the investment portfolio did not perform as anticipated. In recent years, local jurisdictions across the country have faced increased financial stress as a result of their reliance on POBs, demonstrating the significant risks associated with these instruments for both small and large governments. "
Source: https://www.gfoa.org/materials/pension-obligation-bonds

Expected Annual Rate of Return:

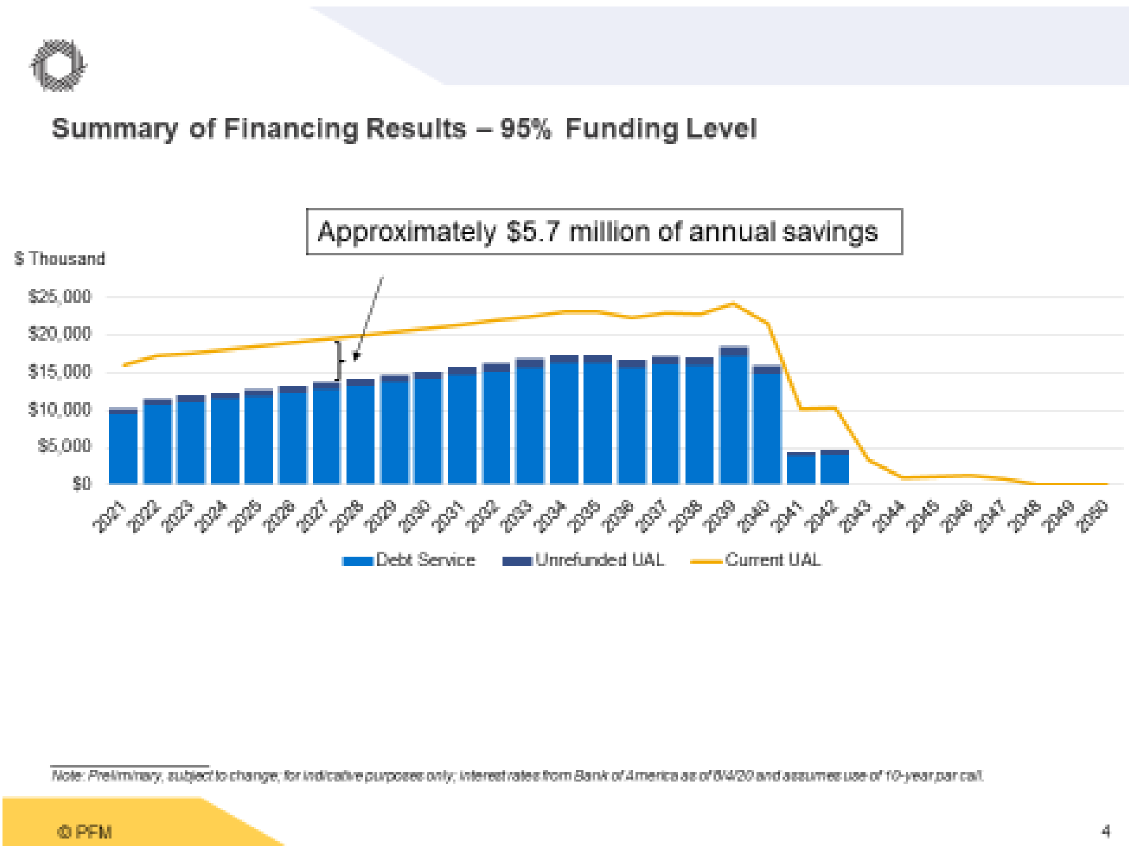
Management projections are based upon an assumed rate of return of 7.9%, aligning with the City's current actuarial assumption as stated in the City's FY2019 Comprehensive Annual Financial Report.

Credible Challenge: Management has reviewed historic returns and is comfortable with the assumed rate of return. The City's net pension liability as of September 30, 2019 was $170,063,521

(B) using the current discount rate of 7.9%. An actual return rate lower than 7.9% would increase the unfunded liability (A), while an actual return rate higher than 7.9% would decrease the net liability (C).

	1% Decrease (6.90%)	Current Discount Rate (7.90%)	1% Increase (8.90%)
Net pension liability (9/30/2019)	A $236,933,522	B 170,063,521	C $114,028,644

The City's net pension liability at September 30, 2020 is expected to be $215,659,515. Management would like the pension obligation bonds to cover 95% of the liability. The chart below shows management's expected annual savings with the POB financing plan, assuming the 7.9% rate of return over time.

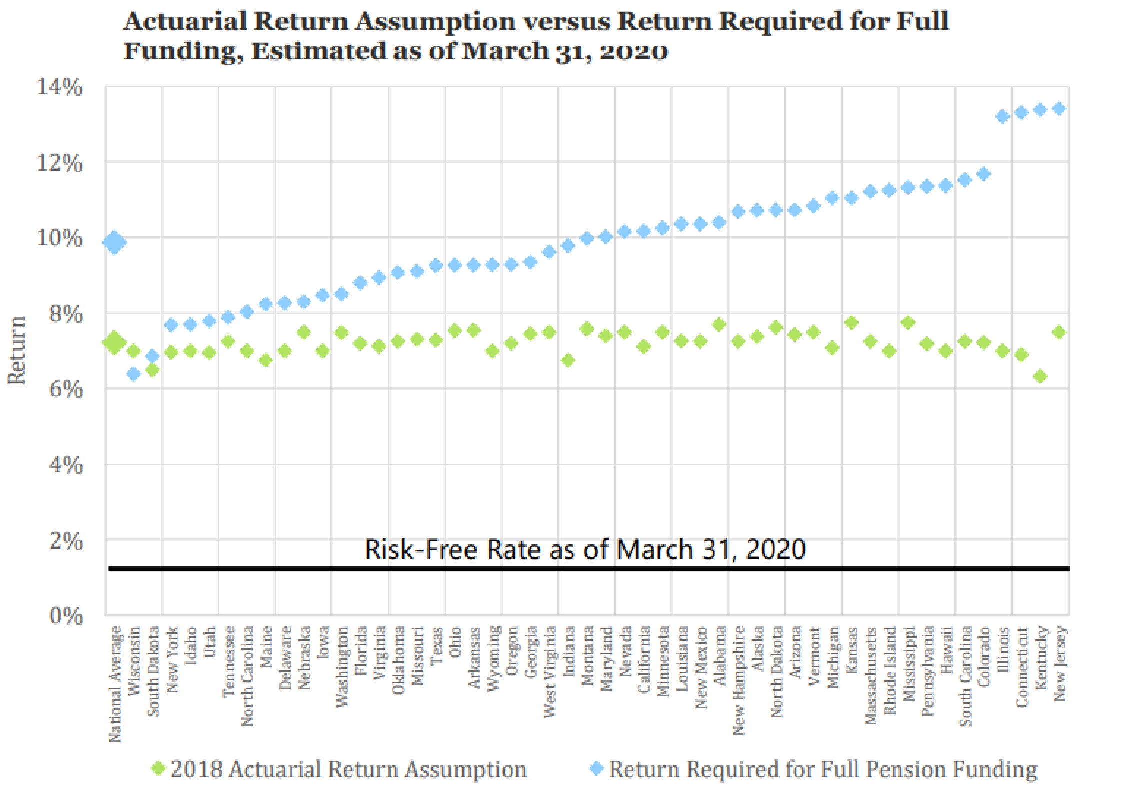


Below are some sources that support using an assumed rate of return lower than 7.9%.

- PEW Charitable Trusts: "Although the timing and shape of a new recession is uncertain, long-term macro projections are unlikely to improve, and so we anticipate this downward trend to continue. These reductions would continue the three-year trend, which already saw assumed annual return rates decline from 7.5% to 7.2%. However, Pew and other experts had estimated that long-term returns would be closer to 6.5% for current portfolios—before factoring in the potential impact of the pandemic."

Source: https://www.pewtrusts.org/en/research-and-analysis/articles/2020/04/23/how-the-market-downturn-could-affect-public-pension-funds

- Research Affiliates, LLC: "A comparison of state pension funds' actuarial return assumption and required return indicates quite a large gap for many states and raises serious concerns about their ability to meet pension obligations without further pension contributions."



Note: Values used in the figure are reported in the appendix.
Source: Research Affiliates, LLC, based on pension data from NASRA (National Association of State Retirement Administrators) and market data from Bloomberg.

Source: file:///C:/Users/bigbiev1/Downloads/The%20COVID-19%20Crash%20and%20the%20Abandonment%20of%20the%20Pensioner.pdf

- National Association of State Retirement Administrators: In an issue brief discussing pension plan investment return assumptions notes that, "…A rate set too high will understate liabilities, undercharging current taxpayers, at the expense of future taxpayers."
  Source: https://www.nasra.org/files/Issue%20Briefs/NASRAInvReturnAssumptBrief.pdf

- S&P Global: In a commentary on an asset portfolio that limits contribution volatility, S&P Global notes that, "With our hypothetical asset portfolio built around our foundations of inflation, liquidity risk, and market volatility, our discount rate guideline for 2020 is roughly equal to 6.0%."
  Source: https://www.spglobal.com/ratings/en/research/articles/200721-credit-faq-pension-and-opeb-guidance-in-u-s-public-finance-credit-analysis-11582116

Percentage of Unfunded Liability Financed:

Management is proposing to finance 95% of the pension unfunded liability through the POB financing plan, which includes a call option at year ten.

> **Credible Challenge**: No challenge. Additional risk is noted when there is no call option. By including the call option, management has reduced the risk of potentially difficult and costly refund or restructure of the POBs.
> *Source: https://www.gfoa.org/materials/gfr-pob-yes-or-no*

Amortization Period

Management proposes a 21 year amortization period for the October 1, 2020 Pension Obligation Bonds financing plan.

> **Credible Challenge:** No challenge. Per S&P Global, "The risk of negative amortization is mitigated when the length of amortization is 20 years or less. Furthermore, a typical U.S. pension plan is likely to have a working population that is expected to average nearly 20 years of employment before retirement, so an amortization of less than 20 years reduces the likelihood of intergenerational inequity, meaning that the funding of an employee's benefits would occur during that employee's tenure."
> *Source: https://www.spglobal.com/ratings/en/research/articles/200721-credit-faq-pension-and-opeb-guidance-in-u-s-public-finance-credit-analysis-11582116*

Covid-19-related Disclosure

> **Credible Challenge**: No challenge. Covid-19 related disclosures, similar to the disclosure below recommended by the SEC to municipal issuers, have been included in the pension obligation bond offering "Risk Factors" segment.
>
> SEC example: "<u>Information Regarding the Impact of COVID-19 on Operations and Financial Condition.</u> Our collective national effort to mitigate the COVID-19 pandemic has caused a deep contraction in vast areas of our economy, with many municipal issuers facing potentially sharp declines in revenues and, in some cases, with increases in un-budgeted costs."
> *Source: https://www.sec.gov/news/public-statement/statement-clayton-olsen-2020-05-04*