# TOWN OF HAMDEN

# PENSION OBLIGATION BOND ORDINANCE INFORMATION PRESENTATION

July 24, 2013

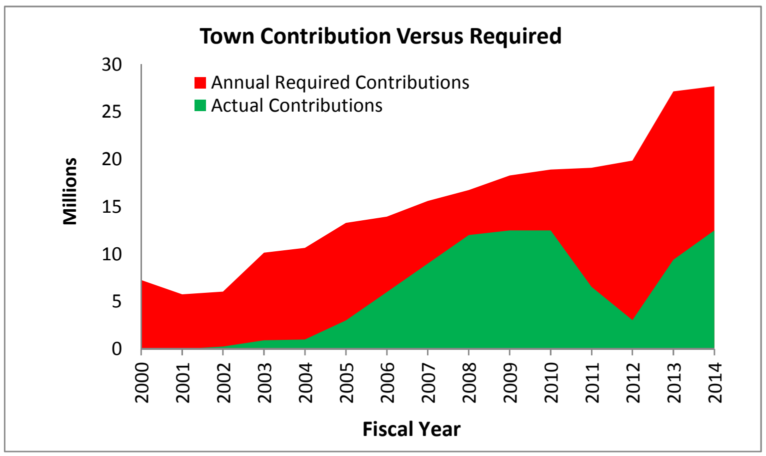
# HAMDEN PENSION LIABILITY

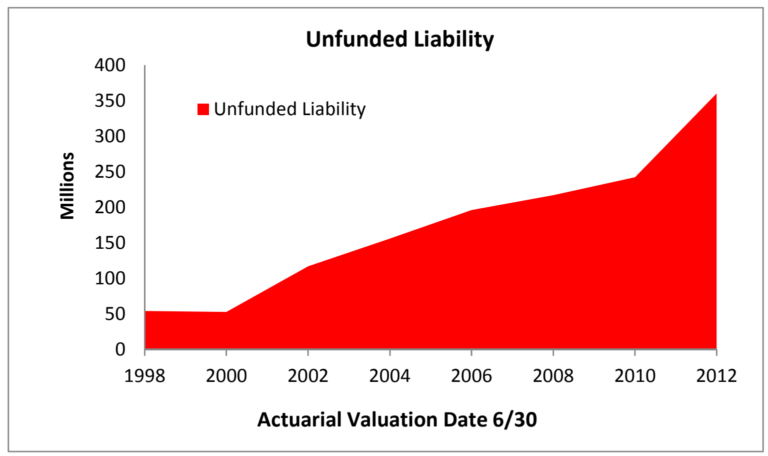
## *2012 Actuarial Valuation*

- According to the Town's Actuarial Valuation as of July 1, 2012, the Town has an unfunded actuarially accrued liability ("UAAL" or "Unfunded Liability") in **excess of $360 million** in its Retirement Plan

  - funded ratio had declined to 14%

- Market value of current assets of $58 million* cover **less than five years** of benefits at current annual funding levels
- In addition to the unfunded liability payments, the Town also pays Normal Costs for accruing benefits which constitute the Town's Annual Required Contribution ("ARC")
- The Town has historically underfunded its Annual Required Contribution, leading to a 565% increase in its Unfunded Liability since 1998
- Every dollar of underfunding increases the unfunded liability on a continuing basis




*As of July 2013, current assets are approximately $50 million and declining by approximately $1.9 million per month

# SEEK VOTE ON POB BOND RESOLUTION

*Why Approve the Bond Measure Now?*

- The Town is regularly reviewed by credit rating agencies for its long and short-term ratings, and is being monitored for further ratings action
- Town has been telling rating agencies over the past year that it will take action to address its unfunded pension liability

  - The Town has shared with the rating agencies the results of the Segal Pension Study

  - Town was recently downgraded to its current A3/A/BBB+ ratings largely due to its pension liability challenges

  - All three rating agencies maintain a negative outlook on the Town

  - Inaction or a perceived lack of progress could lead to further downgrades (Chicago was recently downgraded 3 notches from Aa3 to A3 due to its pension liability)

  - Downgrades will significantly increase the Town's interest rates on future borrowings and potentially limit the universe of the Town's investor base
- In addition, if no action is taken, the dwindling pension plan assets will need to be reinvested into more conservative/liquid investments, such as short-term bonds, to pay for current benefits

  - Reinvestment in short-term investments will further increase the Town's unfunded liability due to the lower rate of return
- POBs make sense the most when there is a reasonable spread between assumed rate of return on the pension plan (7%) and the overall interest rate cost on the POBs (6% or less)

  - Interest rates have increased recently and may face upward pressure in the near term

  - 3 months ago, the 30-year treasury rate was 3.10%, now, the 30-year treasury rate is 3.60%. The increase in interest rates have reduced pension proceeds deposit by $16 million

# PENSION OBLIGATION BONDS

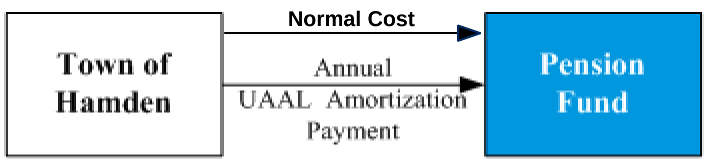
*Overview*

- Taxable Bonds issued to finance a portion of the Retirement Plan Unfunded Liability
- Proceeds of Bonds are deposited in Retirement Plan and cannot be used for any other purpose
- Town's responsibility to make unfunded liability payments are partially replaced with principal and interest liability to bondholders
- Town's responsibility to its Retirement Plan does not change – the Town will continue to pay Normal Costs and payments on the remaining Unfunded Liability, and if a future Unfunded Liability accrues, it would be required to fund that as well
- Net effect is to restructure the Town's annual pension cost

# PENSION OBLIGATION BONDS

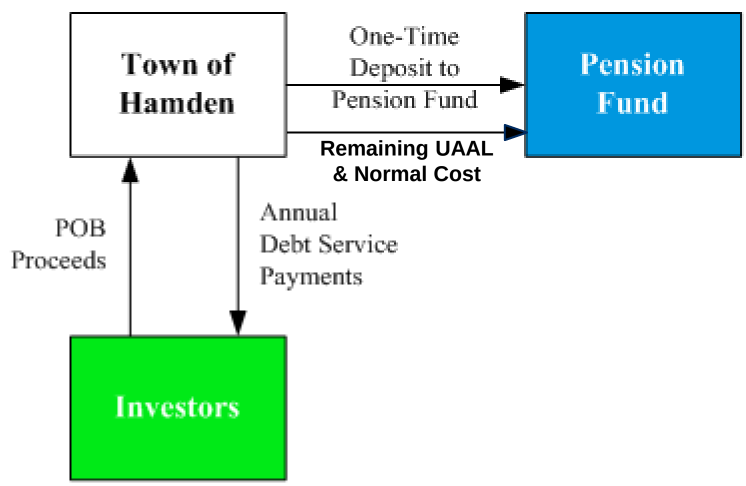
## *Before and After POB Issuance*

**Current Plan**




- Make Unfunded Liability payments that are projected to pay off the Unfunded Liability over the remaining 29-year period ending in 2042
- The Town's current total Unfunded Liability of $360 million will increase if the Town fails to contribute up to the ARC
- Inherent in the liability stream is a 7.0% actuarial earnings rate on plan assets

**After POB Transaction***




- The Town issues Pension Obligation Bonds
- The Town's obligation to make Unfunded Liability payments are partially replaced with principal and interest payments to bondholders

* The Town will continue to pay Normal Costs as part of its Annual Required Contributions. A partial funding of the Unfunded Liability will require additional payments to fund the remaining Unfunded Liability.

# PENSION OBLIGATION BONDS

## *Expected Benefits*

- Infusion of cash from POBs will extend Retirement Plan solvency and potentially ease transition to more sustainable funding plan
- The POB debt service can be structured to meet the Town's financial and policy objectives
- The Town is funding its POBs in a relatively low interest rate environment
  - Interest rates have increased recently and may face upward pressure in the near term
  - 3 months ago, the 30-year treasury rate was 3.10%, now, the 30-year treasury rate is 3.60%. The increase in interest rates have reduced pension proceeds deposit by $16 million
- Effective tool to manage/mitigate required contribution rate increases
- Allows the Town to increase its Retirement Plan reserves without harsh or impractical one-year tax increases
- Pension benefits and other programmatic aspects of the Retirement Plan are unaffected by POBs
- Bond market participants are familiar with and receptive to POBs
  - Bond Insurer
  - Rating Agencies
  - Institutional Investors

# ADVANTAGES AND DISADVANTAGES OF POBS

## Pros

- Partially fund the UAAL, would increase funding level from 14% to approximately 40%
- Convert existing liability into a less expensive form of debt
  - Reduce annual payments
  - Generate significant expected present value savings vis-à-vis actuarial earnings rate
- Restructure payment obligations based on the Town's budgetary preference
- Relatively low interest rate environment
- Historically wide spread between borrowing cost and actuarially assumed investment rate provides positive arbitrage opportunity
- After issuing POBs, the Town will be **legally** required to fund its ARC, forming permanent pension solution

## Cons

- Savings are not known until the POBs are fully amortized
  - More vulnerable to short-term investment performance; exacerbated by large one-time investment of POB proceeds
  - Earnings below the actuarial rate and above the bond rate reduce expected savings
  - Earnings below the bond rate result in dissavings
- Subject to State review process and annual reporting
- If pension asset returns fall below expectations, the Town must have a plan to fund back to post POB issuance level
- Today, the Town is **not legally** required to fund its ARC. Debt service on POBs must be paid, and under State law, the Town would be required to fully fund the ARC each year after issuing POBs

## CONSEQUENCES OF APPROVAL OF THE BOND RESOLUTION

- Allows the Town to file notice of issuance of POBs with the State for their comments and recommendations

  - State does not have approval rights, can only provide recommendations which could be important for rating agencies

  - State has 15 days to request additional information and 30 days to issue written review, including recommendations, once all information is received

- Authorizes POBs issuance of up to $125 million

  - Actual bonds issued will be dependent on interest rates at time of issuance such that non-capital debt service does not exceed 4% of budget (Charter limitation)

  - Town may delay issuance for limited time until interest rates decrease (if at all)

- Commits Town to appropriating ARC each year

  - Connecticut General Statute requires annual valuations and Town to report actual contribution versus ARC

- Town to propose “ramp up” of ARC to full ARC after five (5) years

  - State may not agree and could require the Town fund up to the full ARC immediately

  - Subsequent legislative councils cannot repeal ordinance by State law

## WHY INACTION IS NOT AN OPTION

- Retirement Plan will run out of money within 5 years unless contributions are dramatically increased, resulting in much higher taxes

  - Segal presentation (January 2013) indicates POB bonding, combined with full ARC payments and COLA adjustment is the least expensive viable option

- If nothing is done, the Town is likely to be downgraded by one or more rating agencies leading to a much higher interest costs when issuing new debt

- If the Town and Legislative Council does not act to meet Retirement Plan obligations and defaults, the Town could lose market access and the State could form an Financial Oversight Board to restructure the Town's finances (e.g., Waterbury, CT)

  - Town will be forced into making wholesale draconian changes (e.g., Waterbury's mill rate increased from 74.6 to 98.8 mills following the takeover)
  - State will hire lawyers for protracted negotiations over all financial aspects
  - Town obligations will eventually be restructured
  - Cost much greater to Town, taxpayers and Retirement Plan beneficiaries

# POB AS ONE COMPONENT OF A FUNDING PLAN

## *Pension Obligation Bonds*

- Pension underfunding is an issue confronting municipal issuers throughout America, with national State unfunded liabilities estimated at $2.7 trillion in 2011[(1)]

- Other municipalities in New England have issued Pension Obligation Bonds including:
  - State of Connecticut, New Britain CT, Naugatuck CT, Stratford CT, Waterbury CT, Bridgeport CT, Brockton MA, Worcester MA, Portland ME, Lewiston ME, Bangor ME, Manchester NH, Woonsocket RI and several others

- Issuing POBs is not the solution, but could be an effective component of an overall plan to address the pension funding problem
  - Pension reform is an integral component of the solution

- The combination of the following can achieve long-term solvency without requiring dramatic and sustained increases in Town's contributions or extreme benefit cut backs:
  - immediate injection of cash (i.e., POB);
  - maintain funding discipline;
  - increase Town contributions; and
  - reduce benefits

(1) 2012 Wilshire Report on State Retirement Systems