Providence Pension Reform and Pension Obligation Bond Working Group

MAYOR JORGE O. ELORZA
CITY OF PROVIDENCE

Pension Obligation Bond Proposal

Meeting #3

September 20, 2021

Introduction of Mayor Jorge O. Elorza and City Council President John J. Igliozzi

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- Welcome and Introduction of Working Group Members:
- Rico Vota, Deputy Director of Legislative and Intergovernmental Affairs, Governor's Designee
- Stephen Whitney, Senate Fiscal Advisor-Senate President's Designee
- Rep. Camille Vella-Wilkinson (District 21) Speaker of the House Designee
- Councilwoman Helen Anthony, Providence City Councilor, Ward -2 -City Council President's Designee
- Pedro Espinal, Providence City Council President-Pro-Tem -City Council President's Designee
- Laurie White, President and CEO Greater Providence Chamber of Commerce
- Michael DiBiase, President and CEO Rhode Island Public Expenditure Council
- Cliff Wood, Executive Director, Providence Foundation
- Kristin Fraser, Partner KPMG
- Macky McCleary, Partner innogy Consulting
- Honorable Samuel D. Zurier, Former Providence City Councilperson (Ward 2)

Presenters and Panelists in the Series

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- Seth Williams, Director Management and Budget Consulting
  PFM Group Consulting LLC
- Maureen Gurghigian, Managing Partner, Hilltop Securities, Inc
- Adam S. Krea, Managing Partner, Hilltop Securities, Inc
- Brian Whitworth, CFA Senior Vice-President, Hilltop Securities, Inc.
- Kathleen A. Riley, FSA,MAAA, EA, Senior Vice President and Actuary, Segal Company
- Eric Bertonazzi, Chairman, Chief Executive Officer and Chief Investment Officer, Wainwright Investment Counsel, LLC
- William M. Dolan, Attorney Shareholder
  Adler, Pollock and Sheehan P.C.
- Karen S.D. Grande,
  Partner Locke Lord LLP

City of Providence Administration and City Council Staff Providing Support to the Group

- Nicole M. Pollock, Chief of Staff, Mayor’s Office
- Jeff Dana, City Solicitor
- Lawrence J. Mancini, Chief Financial Officer
- James J. Lombardi, III, Chief of Staff to City Council and City Treasurer
- Gina M. Costa, Internal Auditor
- Theresa M. Agonia, Chief of External Affairs, Mayor’s Office
- Matthew Shumate, Deputy Chief of Staff, Mayor’s Office
- Sara Silveria, Finance Director
- Krystle Lindberg, Deputy Finance Director and Budget Officer
- Emmanuel Echevarria, Chief Human Resources Officer
- Kenneth Chiavarini, Senior Deputy City Solicitor

CITY OF PROVIDENCE PENSION OBLIGATION BOND PROPOSAL (POB)

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Why we must act now to invest in Providence's future.

Prepared: June 2021
Revised: September 2021

Overview

- Long-term Financial Overview
- Why is the City pursuing this?
- Why a POB?
- Details of POB Proposal
  - Current Pension Payments vs. POB Pension Payments
  - Stress Testing
- Process and Next Steps

How did we get here?

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- In the 1990s and 2000s:
  – The City failed to make 100% of the actuarially determined contribution (ADC) to the pension system.
  – Provided retirement benefits that exceeded what the City could afford.
- **The pension system is just 22.17% funded and the Unfunded Liability (UAL), or debt, totals $1.265 billion as of 6/30/20.**

Actions accomplished to date

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- Mayor Elorza and previous administrations have taken steps to fix the problem:
  - Cicilline administration reinstated full pension payments.
  - Taveras administration brokered retiree reform and a new payment schedule.
  - As of this year, the City will have made 10 consecutive years of 100% actuarially determined contribution (ADC) to the pension system.
    - $93.5 million contribution to the pension in Fiscal Year 2022.
  - Boosted the City's credit rating (BBB+).
  - Continued CBA reform to reduce normal costs. Negotiated increased annual employee contributions from the Fraternal Order of Police (FOP) Lodge #3 to among the highest in the state (13.5%), reducing the long-term pension liability by $25-$30 million.

Why a POB?

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- **We are on an unsustainable path and doing nothing is not an option.**
  - Contributions have steadily increased by an average of nearly 5% per year, outpacing the growth of the City's tax base.
  - Even with 100% pension payments for 10 years, we are only at 22% funding.
  - There are risks involved with POB, but they must be balanced with the risk of doing nothing.
- **Stars are aligning.**
  - Current historically-low borrowing costs and favorable market conditions.
  - City's strong credit rating (BBB+).
    - POB unlikely to negatively impact City's credit rating, and in the future will likely positively impact the City's rating.
  - Broad alignment and support at the City level.
    - Mayor, Council President, Unions, members of Providence delegation.

Why a POB?

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- Other options are limited.
  - 10-year freeze of cost of living (COLA) increases ends in 2023 (2012 Consent Decree).
  - The Supreme Court established that the City cannot renegotiate with current retirees.
  - Current retirees comprise 91% of Unfunded Liability.
  - Pensions are a major obstacle to future rating upgrades.

Details of POB proposal

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- The City is proposing a $704M 25-year, fixed rate Pension Obligation Bond with a 10-year par call.
  - Par-call feature allows city the option to refinance in the future after re-evaluating performance.
  - Interest rates between 3.5%-4.25%.
  - ARR of 7% over the next five years, dropping to 6.75% for the remainder of the bond term.
  - Historically, the pension has outperformed this projection (7.6% since inception on 7/1/1996 – roughly the same period as the term of the bond).

POB Projected Payment Schedule

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Fiscal Year Ending June 30	Current Annual Pension Payments	Projected Annual POB Pension Payments	Differential (dollars)
2022	$ 93,585,059	$ 84,026,010	$ 9,559,049
2023	$ 98,475,108	$ 86,026,786	$ 12,448,322
2024	$ 103,611,241	$ 88,167,132	$ 15,444,109
2025	$ 108,806,604	$ 90,373,002	$ 18,433,602
2026	$ 114,268,174	$ 92,646,230	$ 21,621,944
2027	$ 120,009,758	$ 99,098,707	$ 20,911,051
2028	$ 126,045,881	$ 105,720,443	$ 20,325,438
2029	$ 132,391,829	$ 111,311,289	$ 21,080,540
2030	$ 139,063,685	$ 116,942,861	$ 22,120,824
2031	$ 146,078,377	$ 122,611,059	$ 23,467,318
2032	$ 153,013,258	$ 126,807,421	$ 26,205,837
2033	$ 160,767,985	$ 132,558,627	$ 28,209,358
2034	$ 168,921,829	$ 134,315,660	$ 34,606,169
2035	$ 177,495,543	$ 136,115,563	$ 41,379,980
2036	$ 186,510,975	$ 137,964,126	$ 48,546,849
2037	$ 195,991,114	$ 139,853,318	$ 56,137,796
2038	$ 205,960,150	$ 141,790,468	$ 64,169,682
2039	$ 216,443,546	$ 143,776,302	$ 72,667,244
2040	$ 227,468,099	$ 145,808,963	$ 81,659,136
2041	$ 24,067,987	$ 147,896,625	$ (123,828,638)
2042	$ 24,864,637	$ 150,030,446	$ (125,165,809)
2043	$ 25,687,657	$ 152,219,903	$ (126,532,246)
2044	$ 26,537,918	$ 154,461,905	$ (127,923,987)
2045	$ 27,416,323	$ 156,758,760	$ (129,342,437)
2046	$ 28,323,804	$ 159,117,585	$ (130,793,781)
Total	**$ 3,031,806,541**	**$ 3,156,399,191**	**$ (124,592,650)**

Current pension payments vs. POB pension payments

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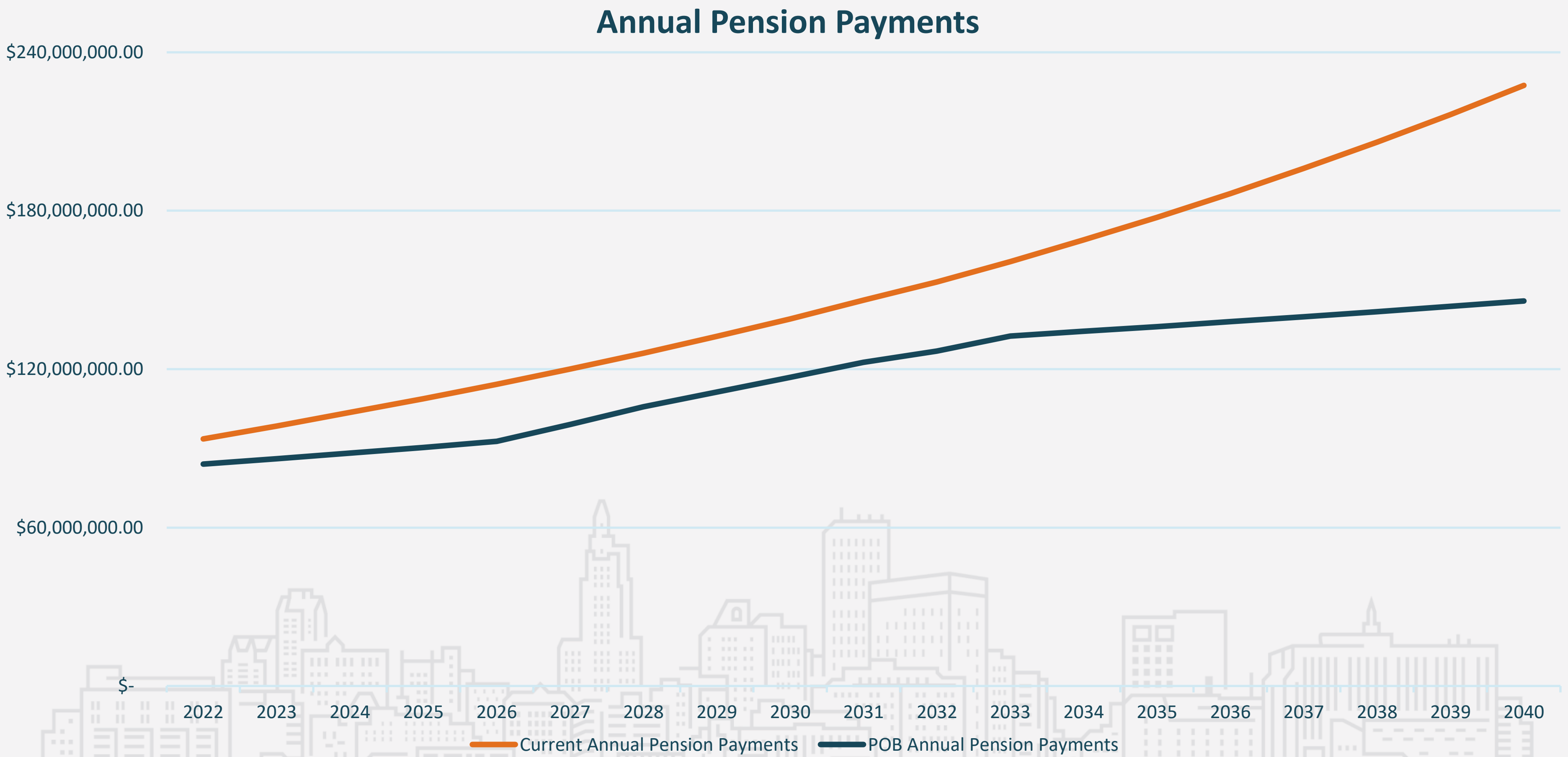

Why the POB is the best advantage for Providence

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- By borrowing now, the City will be taking advantage of the best interest rates we have seen in many years.
  - The principal and interest payments, plus the pension fund payments on the remaining unfunded liability will be less than the current required pension payments, growing at rate more in line with the City's natural tax base.
  - Shifting payments to a more sustainable growth structure will allow the City to make more investments in current day infrastructure and programming for residents and businesses.

RI vs. City of Providence Retirement System Investment Performance

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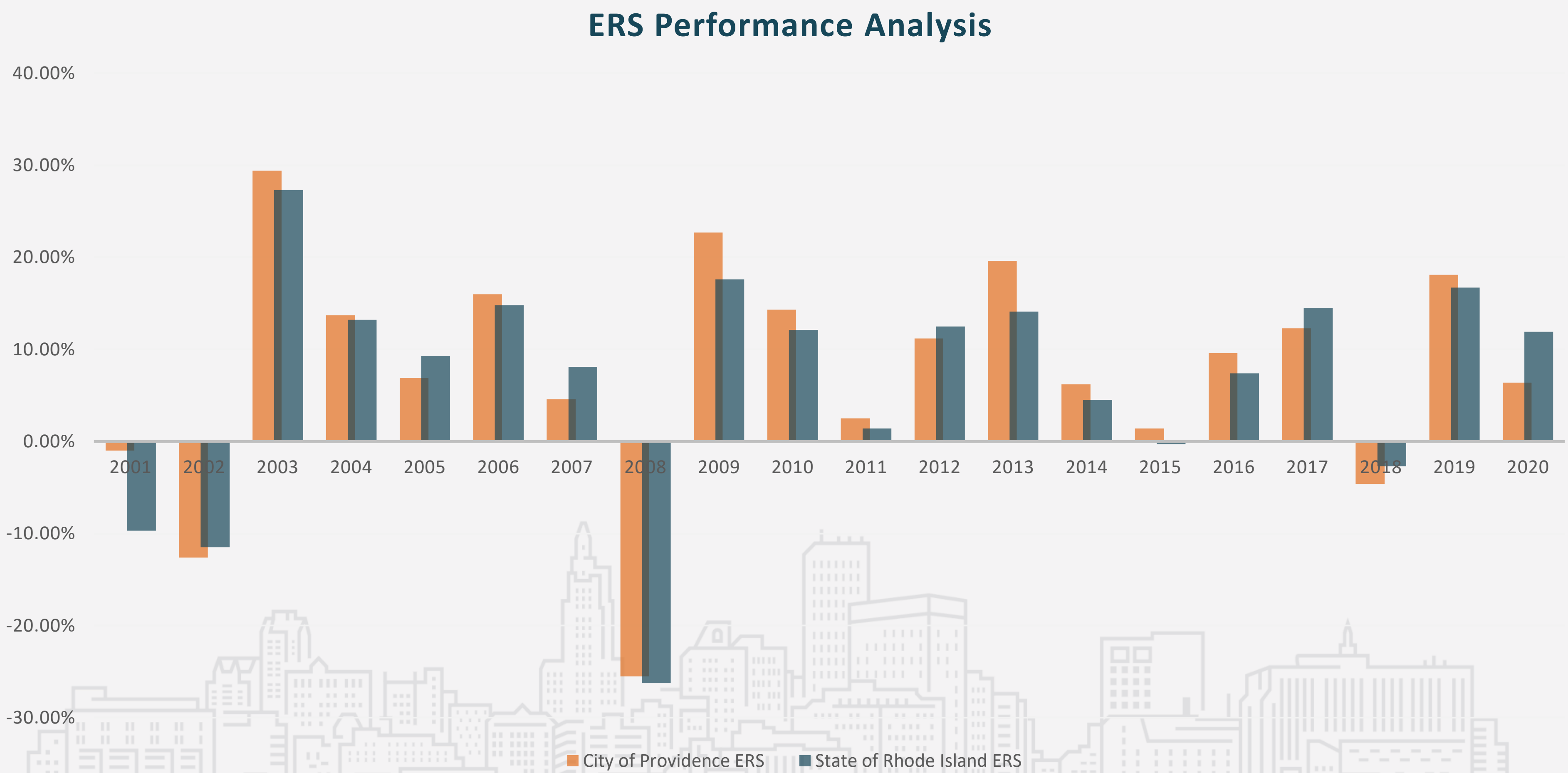

City of Providence ERS Performance

August 1, 2020 to July 31, 2021 Total Returns (Trailing One Year)	24.2%	22.3%	1.9%
August 1, 2016 to July 31, 2021 Total Returns (Trailing Five Year Annualized)	8.9%	10.4%	-1.5%
August 1, 2011 to July 31, 2021 Total Returns (Trailing Ten Year Annualized)	8.5%	8.4%	0.1%
August 1, 2006 to July 31, 2021 Total Returns (Trailing Fifteen Year Annualized)	7.3%	6.8%	0.5%
August 1, 2001 to July 31, 2021 Total Returns (Trailing Twenty Year Annualized)	7.4%	7.0%	0.4%
Total Plan Assets as of July 31, 2021	$368 million	$10.343 billion	

City of Providence ERS return figures were provided by State Street Analytics.
State of Rhode Island ERS return figures were provided by the State of Rhode Island Treasurer's Office website.

Stress Tests For 25-Year, Assumed 4.39% All In TIC, $704 Million POB

Scenario	$ NPV Projected Differential: POB & 25 Year Reamort. vs 25 Year Reamort. UAL with No POB (1)	$ NPV Projected Differential: POB & 25 Reamort. vs Current 19 Year Amort. of UAL with no POB (1)	Investment Returns For Scenario: 25 Yr Reamortized	Investment Returns For Scenario, Current 19 Yr Amortization
Base Case, 7.0% Actuarially Assumed Investment Returns	$ 245 million	$ 154 million	7.0%	7.0%
6.75% Discount Rate	$ 223 million	$ 132 million	6.75%	6.75%
6.5% Discount Rate	$ 204 million	$ 114 million	6.5%	6.5%
5.5% Discount Rate	$ 136 million	$ 46 million	5.5%	5.5%
Breakeven Long-Term Investment Returns	Zero	Zero	4.476%	5.105% (2)
Great Recession Investment Returns (Historic 2008-2012 Investment Returns of the City's Retirement System Repeat After Issuance), Followed by 7.0%	$ 64 million	Negative $ 27 million	CAGR +2.2% first 5 years: 2008 -26.2% 2009 18.0% 2010 12.3% 2011 1.4% 2012 12.5%	CAGR +2.2% first 5 years: 2008 -26.2% 2009 18.0% 2010 12.3% 2011 1.4% 2012 12.5%
First Year Investment Returns That Eliminate Expected Differential (followed by 7.0%)	Zero	Zero	Negative 27%	Negative 15%

Notes: (1) These are summarized results of projections, and there can be no assurance that after the life of the bond issue or at any given point in time there is a positive differential of investment returns versus borrowing costs. NPVs are calculated at 4.0%.
(2) The lower NPV differential for the 19 year UAL amortization leads to a higher breakeven return for POBs than the 25 year UAL amortization. This is due to the 25 year amortization with no POB being more expensive than the 19 year amortization with no POB if NPVs are calculated at 4.0%.

Stress Tests For 25-Year, Assumed 3.85% All In TIC, $704 Million POB

Scenario	$ NPV Projected Differential: POB & 25 Year Reamort. vs 25 Year Reamort. UAL with No POB (1)	$ NPV Projected Differential: POB & 25 Reamort. vs Current 19 Year Amort. of UAL with no POB (1)	Investment Returns For Scenario: 25 Yr Reamortized	Investment Returns For Scenario, Current 19 Yr Amortization
Base Case, 7.0% Actuarially Assumed Investment Returns	$ 296 million	$ 205 million	7.0%	7.0%
6.75% Discount Rate	$ 274 million	$ 184 million	6.75%	6.75%
6.5% Discount Rate	$ 256 million	$ 165 million	6.5%	6.5%
5.5% Discount Rate	$ 188 million	$ 97 million	5.5%	5.5%
Breakeven Long-Term Investment Returns	Zero	Zero	4.175%	4.725% (2)
Great Recession Investment Returns (Historic 2008-2012 Investment Returns of the City's Retirement System Repeat After Issuance), Followed by 7.0%	$106 million	$15 million	CAGR +2.2% first 5 years: 2008 -26.2% 2009 18.0% 2010 12.3% 2011 1.4% 2012 12.5%	CAGR +2.2% first 5 years: 2008 -26.2% 2009 18.0% 2010 12.3% 2011 1.4% 2012 12.5%
First Year Investment Returns That Eliminate Expected Differential (followed by 7.0%)	Zero	Zero	Negative 35%	Negative 22.5%

Notes: (1) These are summarized results of projections, and there can be no assurance that after the life of the bond issue or at any given point in time there is a positive differential of investment returns versus borrowing costs. NPVs are calculated at 4.0%.
(2) The lower NPV differential for the 19 year UAL amortization leads to a higher breakeven return for POBs than the 25 year UAL amortization. This is due to the 25 year amortization with no POB being more expensive than the 19 year amortization with no POB if NPVs are calculated at 4.0%.

GFOA View (in 2015)

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GFOA View (In 2015)	Current POBs
Invested POB proceeds might earn less than borrowing costs.	• Probability of market earning less than ~4% is low (but they do exist) • Stress test will better quantify risk.
"Issuing taxable debt to fund the pension liability increases the jurisdiction's bonded debt burden and potentially uses up debt capacity…"	• The pension liability is already a "hard" debt. • With GA approval, POB will not count towards 3% cap.
Pension bonds are complex instruments that carry considerable risk… and may include swaps or derivatives.	• Criticism is outdated. • No derivatives, swaps, or variable rates.

GFOA View (in 2015), continued

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GFOA View (In 2015)	Current POBs
Pension bonds are "typically issued without call options" making it more difficult to refund bonds if interest rates fall or a different debt service structure is desired in the future.	• POB would include 10-year par call provision.
"Pension bonds are frequently structured in a manner that defers the principal payments..."	• **POB would not have any interest-only payment years.** • Reduced payments would be <u>**minimized**</u>.
"Rating agencies may not view the proposed issuance of Pension bonds as credit positive..."	• Most recent POB transaction are credit-neutral. • More likely to be credit-positive than credit-negative.

Comparisons to Woonsocket POB

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- The City of Woonsocket borrowed $90 million for its pension fund in 2002.
  - As of June 30, 2019, Woonsocket reported $66,535,000 in outstanding POB debt and an unrestricted net deficit of $290,729,607 due largely to pension and OPEB liabilities.
    - Woonsocket **<u>did not have a par-call option</u>**, as it did not exist in the market at that time. A par-call option would allow a City to buy back the debt and refinance without penalty.
    - Bond proceeds were invested during historically unfavorable market conditions and assumed a much higher rate of return (7.5%).
    - Borrowed at a much higher cost.

Important things to know

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- We would **not** wipe away the debt but rather take advantage of current conditions to either save money in the future like refinancing an unfavorable home mortgage or stabilize the City's annual payments with a predictable schedule for bond payments.
  - The City would also choose to include a 10-year par call feature on at least a portion of the bond to give the City the option to refinance in the future after evaluating the cost.
- This plan is conservative and well thought out, but we are only able to take advantage of this opportunity for a short period of time.
  - This is a once-in-a-generation opportunity that will allow us to address the biggest financial problem our state faces today.

Process and Next steps

- To proceed, the City needs a Special Act of the Legislature. Bills are currently before the House and Senate.
  - The City does not require, nor is it requesting, the state to back or make payments on this bond.
- The City Council must approve the bond borrowing authority.
- The City could close on a bond, if approved by the General Assembly, as early as within 60 days from GA approval.

Process and Next steps

- Once passed, the City Council and Administration will work with a team of financial consultants to re-amortize the City's payment schedule and issue a bond.
- The City is currently reviewing proposals for updated Investment Advisory and Investment Council services.
  - These include required responses to the proposed POB transaction and how each respondent would advise the City on transitioning the bond proceeds to pension investment assets.

Pension Reform Overview
Legal Constraints

Presenters and Commentators:

- Jeffrey Dana, City Solicitor, City of Providence
- William M. Dolan Esq., Adler Pollock and Sheehan

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Q & A

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THANK YOU

City of Providence