Review of PA 575 of 2018: Pension and OPEB Bond Obligation Issuance Update

Seminar

May 23, 2019

The Michigan Municipal Managers Collaborative

Review of PA 575 of 2018

History & Authority

- Section 518, Act 34, Public Acts of Michigan, 2001, as amended (MCL § 141.2518)
- Added in 2012; Extended without amendment in 2014, and 2015
- Extended again December 28, 2018 with substantial amendments
- Authority to issue pension obligation bonds (POBs) and other post-employment benefit obligation bonds (OPEBs) pre-Act 575
  - POBs in connection with partial or complete cessation of accruals to or closure of DB plan to new or existing employees and implementation of a DC plan to fund all or part of the costs of Unfunded Pension Liability
  - OPEBs to pay the costs of the Unfunded Accrued Health Care Liability; no requirement to link with closure of benefits plan
  - No election required
  - Comprehensive Financial Plan; AA rating category; Treasury approval

Act 575 – New Legal Requirements

- Issue on or before December 31, 2023; credit rating in "A" category or higher
- Comprehensive Financial Plan be completed and approved by municipality ***before*** notice of intent is published
  - Increases the amount of time it takes to issue pension/OPEB bonds
- Financial Plan posted in a "prominent and conspicuous" location on municipality's website and made available for review at Clerk's office no later than the date the notice of intent is published
- If plan has 100 or more active and retired members, municipality must conduct an internal or external audit to verify plan members' eligibility and benefits within one year prior to the issuance of bonds
- Debt service cannot materially deviate from level or descending annual debt service
  - In the first five years, debt service on the bond issue can increase as long as overall debt service is level or descending when taking into account other securities of the municipality
- ***Net present value savings equal to or greater than 15% for POBs and 20% of par for OPEBs***
- ***Can't fund a previous year's undfunded ARC with any proceeds of pension bonds***
- The final maturity of pension and OPEB bonds can be no later than the date the final amortized payment would have been made without bond financing.

Act 575 – New Legal Requirements (cont'd)

- **Comprehensive Financial Plan must include:**
  - An analysis of the current and future pension **AND** OPEB obligations of the municipality
  - Evidence that the bond proceeds and other funds legally available will be sufficient to eliminate the unfunded liability
  - Debt service amortization schedules; current interest rates; current rates plus 0.5%; current rate minus 0.5%
  - Net present value savings reports for each of those scenarios
    - Expected UAL rate of return
    - Expected rate minus 1%
    - Expected rate minus 2%
  - ***Debt limit calculation in accordance with constitutional, statutory, and charter limits***
  - ***A comparison of the current actuarial plan assumed investment rate of return with the actual investment returns of the plan for the past year, 5 years and 10 years***
  - ***Acknowledgement that after issuance the unfunded liability could increase, and the municipality may have additional required contributions beyond debt service***
  - ***Certification that the municipality's most recent audit show the municipality funded at least 100% of its actuarially determined contributions [for the prior 3 years]***
  - Certifications by the person completing the Plan that it is complete and accurate ***and municipality is PA202 compliant*** (governing reporting of pension and OPEB liabilities, among other things)
  - For OPEB Bonds: a description of the municipality's plan to mitigate increases in health care costs (such as the implementation of a wellness program)
- **The plan may also include:**
  - A summary of list of steps the municipality has taken to reduce the post employment liabilities (pension & OPEB)
  - Analysis showing the projected savings using different rate of return and bond interest rate assumptions
- **The final Comprehensive Financial Plan must be posted in a prominent and conspicuous location on the municipality's website not later than date Notice of Intent to Issue Bonds is published**

Act 575 – New Legal Requirements (cont'd)

- The recent amendments limit the bond amounts to funding levels of:
  - **95%** of pension liabilities
  - **60%** of OPEB liabilities
- In determining the funding level and bond amount, the following may be used:
  - Actuarial Value of Assets (using a smoothing of investment losses and/or gains)
  - Market Value of Assets within 150 days of the bond closing
  - Cost of issuance of the bonds
  - Bonds may NOT include capitalized interest (interest payments on bonds)
  - **60%** of OPEB liabilities
- If municipality wants to use the higher of the values, an explanation must be provided
- With the addition of savings thresholds, several issuers that financed unfunded liabilities, would not have met the new savings thresholds

Act 575 – New Legal Requirements (cont'd)

- Act 575 imposes a structuring limitation—debt service can't materially deviate from level or descending debt service
- But, if Treasury approves, pension/OPEB bond debt service can increase during first 5 years if coordinated with issuer's other debt to maintain level debt service overall
- Work with MA to structure pension/OPEB debt service in relation to Issuer's other debt
- The Department of Treasury encourages the municipality to read its Best Practices and Strategies. Go to Michigan.gov/MSB and under "Documents" click on "Best Practices and CAP Criteria," and then "Click here."

Legal considerations

- PROS
  - Issuing pension bond obligations under Sec. 518 of Act 34 does not require an election—assuming no referendum petition is filed
  - Eliminate or partially eliminate unfunded liability—assuming valuation assumptions are realized
    - If assumptions are realized, then Issuer generally saves difference between amount of payments without bond financing and amount of payments with bond financing
  - Take advantage of potential investment returns
- CONS
  - Takes up debt capacity that may be needed for other tangible infrastructure
  - Lose flexibility by fixing annual debt service
  - Market risk; assumptions aren't realized
    - Fundamental risk of pension/OPEB financing strategy is that assumptions aren't realized (rate of return, mortality, etc.)
    - Results in additional ARC in future years while bonds are outstanding (pension/OPEB bonds don't guarantee elimination of future liability)

Debt Limits

- Constitutional or statutory?
  - Counties – Constitutional, 10% of SEV
  - Home Rule Cities, Villages, & Charter Townships – Statutory, 10% of SEV + additions for constitutional and statutory revenue sharing
  - General Law Townships – None; Practical-Financial

Resolutions

- Cease DB benefits; Close DB plan(s); implement DC plan(s) Initiating Resolution; ***<u>hybrid plans don't meet statutory requirements</u>***.
  - Authorize officials and staff to prepare comprehensive financial plan, obtain/conduct pension/OPEB plan review (if required)
  - Ratify prior action(s)
- Resolution approving notice of intent and publication; 45-day referendum period
  - Form of notice prescribed by Section 517 of Act 34
  - Must have approved and posted CFP prior to publication
- Bond Resolution

Lessons Learned

- Document reasons for financing each plan and rejecting alternatives; incorporate in CFP?
- Plan for what valuation report(s) will be received, when, and how the report(s) and timing will impact the financing timeline
  - Market valuation of assets would likely result in an increased bond amount, be ready to justify financing the higher amount
- Give your municipality (and yourself!) ample lead time to complete, understand, and check off all financing requirements
- Remind your councils, commissions, and boards early and often that performance depends on rate of return and assumptions
  - Failure to meet assumptions and/or rate of return may require additional future ARC + debt service
  - Funding to the maximum amount allowed doesn't guarantee elimination of liability
- A closed and financed plan must stay closed while bonds are outstanding