

POLICE AND FIRE PENSION FUND

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"We Serve... and We Protect"



December 29, 2008

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John Keane
Executive Director -
Administrator

Ronnie Fussell
City Council President
City of Jacksonville
117 West Duval Street
Jacksonville, Florida 32202

RE: City's Issuance of Capital Appreciation Bonds

Dear Council President Ronnie Fussell:

During our recent discussions regarding the City's pension plans you expressed interest in exploring various strategies for addressing the Unfunded Actuarial Accrued Liability (UAAL) of the PFPF in the face of the City's upcoming budget pressures. During our discussions we covered the subjects of Pension Obligation Bonds and real estate transfer programs. We also focused upon the fact that the current UAAL of the PFPF is scheduled to be amortized over the next 21.5 years, whereupon the City's pension contribution rate to the PFPF would be reduced to a very affordable 8.18%.

Drawing upon your experience in the real estate industry, you noted that many homeowners who are approaching periods of budget stress consider refinancing programs that act to stretch out mortgage payments and in turn lower their monthly budgetary outlays over the immediate future. In the spirit of this concept, we have developed a financing option that would produce a similar impact to the City as it considers strategies to deal with its upcoming budget pressures. This program involves the use of City-issued Capital Appreciation Bonds (sometimes called CAB's, Zero Coupon Bonds, or simply Zeroes) which would be transferred to and treated as assets of the PFPF.

The potential issuance of such CAB's by the City are contemplated to be issued with maturities structured in the periods after the full liquidation of the UAAL in 21.5 years. The inclusion of new PFPF assets in the form of City issued CAB's would lower the value of the UAAL by the original and then accreting (or progressively growing) value of the CAB's. The reduced value of the UAAL would translate into a reduced annual amortization requirement from the City. For instance, the UAAL currently represents 23.93% of the City's total contribution requirement of 32.11%, with the normal cost representing the remaining 8.18%. This 23.93% element would be materially reduced as a result of the City's issuance of CAB's and their placement into the PFPF. The amount of the annual reduction would depend upon the dollar value of CAB's issued by the City. **The net impact of this transaction would be to**

stretch-out the current 21.5 year amortization period to a longer amortization period, with a reduced annual budgetary outlay.

We have attached Exhibit A as an illustration of the way in which CAB's operate. In this illustration, we have assumed the issuance of CAB's bearing an interest rate of 8.5% (the actuarial interest rate assumed for the Fund) with each Bond carrying a maturity value of \$1 million and annual maturity dates ranging from 2031 to 2038. Each \$1 million bond is assumed to be issued on September 30, 2009 with an accretion value, representing the \$1 million maturity value discounted back to the issuance date at a discount rate of 8.5%. Under this structure, all of the principal and all of the interest is paid at the maturity of the CAB to the bond owner (the PFPF). Accordingly, the City would be able to pack all principal and interest payments subsequent to the end of the current 21.5 year amortization period. The table at the bottom of Exhibit A conveys the point that all debt service payments (both principal and interest) are made in the "out years".

The issuance of CAB's to the PFPF could be accomplished by the City in a very economical manner. There would be no need to involve outside bond counsel, a team of underwriters, bond paying agents, financial advisors, credit facilities, rating agencies, bond printers or the development, printing and distribution of an official statement. It could be accomplished by the mere adoption of a City Council Ordinance authorizing the issuance of bonds with the form of each bond attached thereto. There would be no need for the City to earmark and offer a pledge of its traditional (market accepted) revenue streams to secure the bond instrument inasmuch as the securities could be secured by the City's mere "covenant to budget and appropriate" the necessary funds to cover each final CAB maturity. Accordingly, the City could preserve its more highly desirable and low cost revenue bonding capacity for traditional capital programs.

Once established, the CAB program could be managed in a very flexible manner. The City could use an invested sinking fund without fear of running afoul of federal arbitrage laws. In addition, the City and the PFPF could agree to establish a Bond Redemption Fund that could assemble funds from future actuarial gains that may present themselves over the current 21.5 year UAAL amortization period. The existence of such gains (essentially representing the accelerated liquidation of the UAAL) could be earmarked as the source for the stipulated extinguishment of CAB's, thus allowing the City the ability to avoid the payment of scheduled bond maturities to the PFPF. This aspect recognizes the fact that the CAB's were created as a source for the repayment of the UAAL and if elements of the UAAL happen to be paid off from actuarial gains, there is no need for a portion of the CAB's to duplicate this role. Accordingly, the program could be established in a very flexible manner and free of the costly need to pay bond premiums to bondholders for the early extinguishment of debt which would be required for traditional debt instruments.

In an effort to further illustrate the use of CAB's in the above described manner, we would like to take this opportunity to offer additional details on how such a program might operate. As previously mentioned, the amortization of the UAAL currently requires 23.93% of the City's 32.11% contribution rate. The \$534 million value of the UAAL that drives this contribution requirement could be thought of as a City bonded indebtedness that is amortized over a period of 21.5 years at an interest rate of 8.5%. The amortization of this indebtedness is based upon a fixed percentage applied to a growing payroll base. Accordingly, the dollar value of the amortization requirement grows over this 21.5 year period as the member payroll grows, while the percentage rate remains the same. To the extent that the City issues CAB's in the years following the UAAL's 21.5 year amortization period, the dollar value required from the City in the form of City pension contributions during each year of the UAAL amortization would be reduced, with the amount of each reduction providing annual relief to the City's budget over the next 21.5 years.

These concepts are further illustrated in the attached Exhibit B. The chart on Exhibit B displays the City's current annual UAAL amortization requirement ranging from \$36.9 million in 2008 to \$102.6 million in 2028 based upon the current 23.93% annual requirement applied to a growing payroll base from a starting point of \$154.1 million. According to the scenario offered in Exhibit B, the current UAAL obligation could be refinanced through the issuance of \$105.8 million in CAB's with bond maturities ranging from 2029 to 2038. **The refinanced UAAL obligation would be materially reduced over the next 21.5 years under this scenario with annual savings ranging from \$9.0 million in year 1 to \$25.1 million in year 21. In exchange for the issuance of CAB's in this manner, the City could realize budgetary savings of \$344.2 million over the next 21.5 years.**

The \$36.9 million in City Pension contributions described on the attached Exhibit B is derived from the application of the current 23.93% UAAL amortization rate to a (Non-Dropper) payroll base of \$154.1 million. In the event that CAB's are issued in the manner described herein, the assumptions reflected in Exhibit B would cause the City's pension contribution rate to be reduced from 23.93% to 18.07% (\$27,844,954 in pension contributions divided by a payroll base of \$154.1 million) which would continue until the year 2038. These variables are summarized in the table below.

	<u>Status Quo</u>	<u>CAB Option</u>	<u>Year One Difference</u>
PFPF Payroll Base	\$154,108,165	\$154,108,165	\$154,108,165
City UAAL Rate	<u>x 23.93%</u>	<u>x 18.07%</u>	<u>x 5.86%</u>
City UAAL Contribution	<u>\$ 36,878,084</u>	<u>\$ 27,844,954</u>	<u>\$ 9,033,130</u>

The transaction and concepts described above are essentially akin to that of a homeowner making a decision to refinance his home mortgage from 21.5 years to 30 years and in the process reducing the monthly payment. Budgetary relief

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would be provided to the City over the first 21.5 years in exchange for the agreement to make payments over a longer period. Ordinarily, the City may not be particularly interested in pursuing a refinancing technique of this nature. However, given the prospects of increased contribution requirements that are about to emerge for both pension funds in the aftermath of the disappointing returns for FY2008, the budgetary relief described herein may be well timed to assist City budget makers in balancing the FY2010 budget. In the event that the City Council wishes to explore this concept, we could develop a series of more refined and detailed options for further review.

Sincerely,

John Keane
Executive Director – Administrator

cc: Mayor John Peyton
City Council Members
Board of Pension Trustees
Alan Mosley, Chief Administrative Officer
Adam Hollingsworth, Chief of Staff
Mickey Miller, City Chief Finance Officer
Kirk Sherman, City Council Auditor
Dr. Kathleen McKenzie, JCCI Program Director