
**HOUSE COMMITTEE ON PENSIONS & INVESTMENTS
TEXAS HOUSE OF REPRESENTATIVES
INTERIM REPORT 2004**

**A REPORT TO THE
HOUSE OF REPRESENTATIVES
79TH TEXAS LEGISLATURE**

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PENSION OBLIGATION BONDS

Pension Obligation Bonds

BACKGROUND

In the 78th Legislative Session, SB 1696 by Senator Wentworth was passed and went into effect September 1, 2003. SB 1696 authorized political subdivisions of the state to pay unfunded liabilities of public pension funds by issuing pension obligation bonds (POB). Nationwide, pension funds are experiencing a rapid growth in unfunded liabilities driven primarily by investment losses, benefit enhancements and greater longevity of pension plan beneficiaries.

Pension obligation bonds are considered a new tool to relieve the pension system's unfunded indebtedness. While a few POB were issued in the 1980s, they truly came into their own in the 1990s with more than \$10 billion being sold. The average principal amount for POBs ranged from \$100 million to \$300 million with a few exceeding \$1 billion or more. Over the last 10 years, there have been over 300 POBs issued totaling \$38.1 billion. Most recently the states of Kansas, Wisconsin and Oregon, and the cities/counties of Allentown (PA), Fresno (CA) and Westchester (NY) have issued POBs.

The POB objective is to fund unfunded pension liabilities as a long-term investment. Using POBs for short-term debt has been compared to using a home equity loan to buy groceries. Bonds are issued by a state or local government that sponsors a pension plan and not by the pension plan itself. Proceeds are deposited in the pension trust fund for investment. The issuing government repays the bonds with general funds.

Standard & Poor's reports, "the goal is for the sponsor to realize savings by paying lower carrying charges for pension contributions and debt service than what is earned by their asset pool. Prior to the POB sale the employer would have been required to make contributions to cover its normal pension costs plus an amount to fund the unfunded accrued actuarial liability (UAAL), an increase in the contribution total. After the sale, the UAAL portion would fall away and be replaced by the lower cost to pay debt service on the POBs."¹ To actually realize a savings, the average annual investment return on pension assets over the life of the POB must be higher than the total interest cost on the POBs. Equaling or beating the pension fund's actuarial investment return assumption is the goal. Historically, this return assumption has been around 8%.

In the 1990s most employers funded the entire UAAL, but for various reasons many now tend to finance less than the full amount. The Cities of Houston, San Antonio and Dallas are examples in Texas that are expected to issue POBs to fund a portion of their UAAL in the near future.

Timing, market conditions and interest rates are key elements in the success of POBs. In the early to mid-1990s, the elements for POBs could not have been better. Returns on domestic equities were sustained at levels well above the historical experience. During this time that POBs

were issued, the funding status of the pension funds were increased to fully funded and some even surpassing the 100% funding mark. Under these circumstances and with their actuaries recommendation, the pension plan sponsors chose to decrease or temporarily eliminate pension contributions. This, in turn, slowed the growth of assets. Some plan sponsors chose to improve employee benefits which instantly increased the fund's liabilities, but also balanced the overfunded status. POBs produced, as promised, an economic benefit and in most cases it was substantial. This, however, lulled the funds into a false sense of security.

RISKS FACTORS

The principle risks to the issuer of the POB fall into a number of categories:

- Arbitrage (Investment return/POB interest cost);
- Leverage;
- Market risk; and
- Political

Arbitrage: POBs are essentially an arbitrage play, the success of which is dependent on the premise that the pension fund assets will earn an average more than the interest cost and investment return rate of the POBs. At the end of the fiscal year 2001, the S&P 500 declined 15.8% (and fell an additional 15% in the next quarter), which was the worst performance since fiscal year 1982.² This decline in the market resulted in a below average return (6%) on the plan's assumptions. Weak investment returns catapulted into lower pension funding levels. This in conjunction with increased benefits adopted during their "overfunded status" had catastrophic results. In this case the investment underperformance over an extended period of time, in addition to the benefit changes, lead to actuarial losses and new unfunded liabilities. This resulted in the need to increase contribution rates to bring the systems back into balance. Many funds now use smoothing methods for actuarial purposes in valuing assets to spread investment gains and losses (typically 5 years). In a long-term lower return environment with declining funding levels, those systems that have taken the bulk of their excess funding out of their POB structure may see trouble ahead.³

Parry Young with Standard & Poor's used the following example in a November 2001 newsletter to illustrate this problem. *"For example, say a state sold POBs in 1985 with a 30-year amortization to fully fund its retirement system and had average annual investment returns of 12% against its investment assumption of 8%. However, instead of permitting the natural increase in the funded ratio that these conditions would have caused, the state managed its funding ratio, through contribution holidays and benefit improvements, to maintain the ratio at around 100%. If we are, in fact, heading into a lower return period (the average annual increase in the S&P 500 for the 16 years from 1966 to 1892 was a meager 2.7%, for example), the state may have already reaped all its gains from the transaction structure and be headed for losses. If actuarial losses start to be incurred, contributions will have to increase. If returns fall below the interest cost on its POB that will mean that the POB will have become a net financial drain. If investment yields fall below POB interest cost, total debt service, including that on the POB, plus normal and new unfunded actuarial accrued liability (due to low returns) contributions, will now be higher than if the POB had not been sold. To judge the full effect of a POB, however, any future losses have to be weighed against prior*

period gains. With a POB, its ultimate success, or failure, can only be judged as it's final maturity is approached. The financial dynamics may be a winning formula for 25 years, for example, and then a losing one in the last five years (or vice versa)."

Leverage: Adding too much leverage is another factor to consider. Borrowing for any purpose increases leverage, and incurring debt to pay unfunded liabilities is no different. POBs are a means of substituting one long-term debt for another. Bond debt service must be paid in full and on time or the issue falls into default with wide ramifications (hard obligation). For certain employers, contribution payments may be temporarily deferred or reduced without serious negative consequences (soft obligation).

Market Risk: Because POBs generate very large infusions of funds into the pension system compared with the more steady investment and reinvestment of interest, dividends and contributions by the fund, the plan for investing POB proceeds must be considered.

Political: There is a political risk with POBs. They can become a victim of their own success. As illustrated earlier, should a POB be issued for the full 100% funding ratio and subsequent higher than average returns result in an overfunded status, political pressure to distribute the illusory "excess" funding by increasing benefits, in turn, incurring new liabilities. Those that fell victim to this overfunded mirage paid the price when the market declined. Prudent expectations for investment returns and the cautious use of resultant savings help insure a POB's success.

CREDIT RATING

Standard & Poor's factors the effects of a pension obligation bond strategy into the long-term rating of the sponsor. They focus on the effect of the bonds with regard to the issuer's debt structure and its ability to meet its obligations. POBs are viewed as a strategy for savings on carrying charges as long as the transaction was structured conservatively and the assumptions were reasonable and attainable. This requires a clear financing plan including reasonable assumptions and manageable leverage.

Standard & Poor's looks at total debt with and without the POB so as not to penalize a POB issuer in comparison to another issuer that might have relatively low debt (and no POBs), but sizable unfunded pension liabilities. Also, they evaluate the leverage added by the POB. Does it markedly increase hard, fixed costs (bond debt service) in place of a softer more discretionary obligation (pension contributions)? If subpar investment returns put upward pressure on contribution rates will they, coupled with the new higher debt service costs due to the POB, put the issuer's budget under greater strain? The issuer must also be cognizant of the effect the POB issuance may have on statutory debt limits. Will the POB use up debt capacity that might be needed for other, more pressing needs?⁴

From a cash flow standpoint, Standard & Poor's reviews projected debt service and contribution costs, with and without the POB, including the validity of the assumptions including for POB interest costs and pension fund investment returns. How do the projections compare in total and on an annual basis? The spread between interest costs and investment return generates the

savings expected from the transaction. The analysis of cash flows is a critical component to understanding the full impact of the transaction.⁵

A review of the current status of the recipient of bond proceeds - the pension system itself. What is the statutory relationship between the issuer/employer and the fund? How have the laws and precedents for making contributions affected funding progress and how do they play into the POB strategy? Have funding levels generally been increasing over time? What are the funding goals and how will the POB impact these objectives?⁶

The pros and cons of POBs should be weighed very carefully. Risks should be carefully evaluated. There should be a clear POB plan with attainable actuarial and investment assumptions and a conservative structure.

It is possible for POBs to have a negative effect on credit quality. An evaluation is done of each employer's individual profile at the time of sale as well as their projected effects over time. POBs may work as planned over the long-term, but short-term fiscal dislocations resulting from these structures are part of their baggage.

CONSIDERATIONS

In testimony received from the Ron Snell with the National Conference of State Legislators the following recommendations were made:

- Bond issuers should have a capacity for added risk
- Bond issue should not be so large that it limits borrowing for other purposes
- An issue should be no more than about 20% of the pension fund's assets (to limit risk, and facilitate investment).
- Debt service should be in roughly equal annual amounts - POBs should not be used to shift financial problems to the future.

MASSACHUSETTS LANGUAGE

Massachusetts requires local governing boards formally to adopt guidelines and language approved by the town council.

**Pension Obligation Bonds
Commonwealth of Massachusetts
Issuance Criteria
April 23, 2004**

Recently enacted, as well as pending home rule legislation regarding the use of pension obligation bonds in named communities stipulates that such bonds may be issued only if, at a minimum, a comprehensive plan is first approved by the Secretary for Administration and Finance. To facilitate submissions by relevant municipalities, the Executive Office for Administration and Finance (A&F) promulgates the following guidelines:

1. A city or town operating its own retirement system:

- a. The local appropriating authority of the city or town must approve the issuance of pension obligation bonds by a two-thirds vote;
- b. The following disclosure language must be accepted by a two-thirds vote, in a town, by the board of selectmen; in a city, by the council with the mayor's approval when required by law; and in a municipality having a town council form of government, by the town council:

THE USE OF PENSION OBLIGATION BONDS MAY INCREASE THE POTENTIAL LOSSES ASSOCIATED WITH PENSION FUND INVESTMENTS. THE COMMONWEALTH IS NOT RESPONSIBLE FOR ANY LOSSES INCURRED BY A MUNICIPALITY DUE TO THE ISSUANCE OF PENSION OBLIGATION BONDS, NOR FOR ANY INCREASE IN UNFUNDED ACTUARIAL ACCRUED LIABILITY DUE TO DEFICIENT INVESTMENT RETURNS.

2. Approval by the Executive Office for Administration and Finance

- a. With regard to cities and towns with credit ratings of "Aa3/AA-" or higher, A&F will ascertain to its satisfaction that:
 - i. Credit Ratings
 1. The city or town is rated by at least two nationally recognized rating agencies;
 2. The city or town's credit rating will not decline below the "Aa3/AA-" category as a result of the issuance of pension obligation bonds.
 - ii. Pension Obligation Bond Structuring
 1. The pension obligation bonds will have a final maturity no later than 2028;
 2. The debt service associated with the pension obligation bonds for the first three fiscal years subsequent to their issuance will be at least equal to the minimum payments required by an amortization schedule

that fully funds the unfunded actuarial accrued liability by 2028 and restricts the increase in amortization payments to no more than 4.5% per year.

iii. Present Value Savings

1. A pension obligation bond issue is projected to generate net present value savings;

2. Present value cash flow savings will be measured as the difference between debt service payments for the pension obligation bonds and the payments that would have been required in lieu of the issuance of pension obligation bonds, based on an amortization schedule that funds unfunded actuarial accrued liability by 2028 and restricts the increase in amortization payments to no more than 4.5% per year;

3. The discount rate will be the true interest cost of the pension; obligation bond issue, including all premiums, discounts, fees, insurance cost and other expenses.

iv. The city or town has complied with guideline 1(b) above.

v. A&F will issue an approval letter to the city or town upon proof of compliance with guideline 2(a) i-iv.

b. With regard to cities or towns with credit ratings lower than "Aa3/AA-", but higher than "Baa2/BBB" A&F will ascertain to its satisfaction that:

i. Credit Ratings

1. The city or town is rated by at least two nationally recognized investor rating agencies;

2. The city or town's credit rating will not decline as a result of the issuance of pension obligation bonds.

ii. Pension Obligation Bond Structuring

1. The pension obligation bonds will have a final maturity no later than 2028;

2. The debt service associated with the pension obligation bonds for the first five fiscal years subsequent to their issuance will be at least equal to the minimum payments that would have been required in lieu of the issuance of pension obligation bonds, based on an amortization schedule that funds unfunded actuarial accrued liability by 2028 and restricts the increase in amortization payments to no more than 4.5% per year.

iii. Present Value Savings

1. A pension obligation bond issue is projected to generate net present value savings;
2. Present value cash flow savings will be measured as the difference between debt service payments for the pension obligation bonds and the payments that would have been required in lieu of the issuance of pension obligation bonds, based on an amortization schedule that funds unfunded actuarial accrued liability by 2028 and restricts the increase in amortization payments to no more than 4.5% per year;
3. The discount rate will be the true interest cost of the pension obligation bond issue, including all premiums, discounts, fees, insurance cost and other expenses.

iv. Financial Capacity

1. A city or town must possess the financial capacity to address additional unfunded liabilities that may arise should returns on pension assets be below the assumed rate of return;
2. A&F's analysis will include, but not be limited to the following:
 - a. Tax levy capacity
 - b. Reserves
 - c. Debt levels
 - d. Management

v. Pension Fund Historical and Projected Return Performance

1. The city or town's historical rate of return on its pension fund over the prior 10-year period must be equal to or greater than its current rate of return assumption.

vi. Pension Fund Management

1. The retirement system's pension assets must be managed by PRIM or by a nationally recognized asset management company;
2. The city or town must provide an asset allocation plan for the proceeds of the pension obligation bond to A&F and PERAC.

vii. Subsequent to A&F Approval:

1. The city or town must provide A&F with the value of its pension fund on a "mark-to-market" basis no earlier than 60 days prior to the issuance of pension obligation bonds;
 2. The city or town will conduct an actuarial valuation of its pension
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assets once every year and report its findings to both A&F and PERAC. If the actuarial valuation of pension assets is less than projected pension liabilities, the city or town must fund this deficiency based upon a PERAC approved schedule.

c. City or towns with credit ratings below “Baa1/BBB+” will not receive written approval from A&F to issue pension obligation bonds.

d. Notwithstanding any provision herein to the contrary, A&F reserves the right to disapprove any request for the issuance of pension obligation bonds; A&F further reserves the right to require the submission of any materials or information it deems necessary for its determination or to waive any requirement listed above.

RECOMMENDATIONS

In an effort to protect the state, cities and counties from the possible dangers associated with the issuance of POBs, it is the Committee’s recommendation that the State of Texas follow the example of the State of Massachusetts in adopting similar guidelines. The Committee believes this language is not a cure-all and strict scrutiny needs to be given to each and every actuarially unfunded pension system before POBs are issued. However, the language of the State of Massachusetts will serve as a starting platform from which we can begin.
