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Time May Be Ripe For A POB Revival

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Despite the prospect of increased funding ratios for public pension funds over the next several years, pension obligation bonds (POBs) may reemerge as a key financing tool for unfunded pension liabilities. The key to this reemergence, after a two-year hiatus, will depend upon actual investment performance in 2008 and 2009, the ability of plan sponsors to make actuarially required contributions (ARCs) in light of uncertain economic and revenue conditions, and burgeoning liabilities for other postemployment benefits (OPEB).

According to the National Association of State Retirement Administrators (NASRA) Public Fund Survey of 2007, public pension fund assets returned a healthy 11.9% on average between 2003 and 2006. Given these very strong returns, which are above the average assumed return rate of 8% for most fund assets, Standard & Poor's Ratings Services expects to see increased average pension funding levels over the next several years. However, NASRA reported that the average ratio of the 112 public pension plans in the survey was 86% in 2006. Although the ratio is still relatively strong, it is down significantly from the fully funded status in 2000 and 2001. In general, funding ratios declined due to poor returns in 2001-2002, benefit enhancements, demographic assumption changes, and underpayment of ARCs by several large state sponsors.

We are already beginning to see some POB activity, with Alaska, Connecticut, Puerto Rico, and Kentucky among the states currently contemplating a large POB issuance to bolster funding ratios and reduce costs. West Virginia recently securitized its tobacco settlement revenues and used proceeds to fund its pension plan, although the issue was not a POB in the traditional sense. POBs have been popular with issuers and successful for the sponsors in the 20 years through 2005, but issuance slowed in recent years because of strong investment returns.

Rating Implications

Employers looking to help manage their unfunded liabilities through the issuance of a POB should carefully weigh the pros and cons. It is also important to understand how the POB fits into the overall debt and liability structure of a prospective issuer. There should be a clear POB plan with attainable actuarial and investment assumptions and a conservative structure. Prudent allocation for projected savings over time limits the chances for problems

POBs could have a negative effect on credit quality if they were structured poorly. Standard & Poor's will continue to evaluate POB risks in light of each employer's profile at the time of sale as well as their projected effects over time. POBs may work as planned over the long term, but could cause short-term fiscal dislocations depending upon actual investment returns.

Brief History

Overall, POBs have largely been successful for the sponsors who have used this strategy. In the past 20 years when the vast majority of these bonds were issued, investment yields overall exceeded investment return assumptions of public pension funds and the interest cost of the POBs, generating actuarial gains for the plans. While a few POBs issued in the 1980s, the first big wave of POBs came in the early 1990s. By the end of the decade, about \$15 billion of POBs had been issued.

The years 2000 and 2001 were slow for POB issuance because of the strength of U.S. public pension funding,

especially in 2000 when the average funded ratio was slightly over 100%, up from only about 80% in 1990. These robust funding gains were fueled by above-average equity returns during the late 1990s and a general shift in the weighting of public pension assets to higher-yielding equity assets from fixed-income assets.

Beginning in 2003, however, public pension funding ratios fell sharply, exacerbated by a combination of adverse circumstances, including the decrease in pension asset values due to poor equity returns following the dot-com bust in 2001-2002, the increase in liabilities from benefit enhancements put in place during that time, and demographic changes, such as increased member longevity. These factors created the second significant wave of POBs in 2002-2005. As in the first wave, California counties led the pack, and there were a number of repeat borrowers, but there were also significant new players. The state of Illinois, which issued a POB in June of 2004, holds the POB record for sheer size at \$10 billion — almost four times larger than the previous record. Oregon, Kansas, and Wisconsin, have completed \$1 billion plus POB sales in recent years.

POB Mechanics

Complex financial implications, simple execution

While the financial implications of POBs are complex, the actual mechanics are relatively simple. Generally, the municipal employer will use the findings from the most recent actuarial valuation, or have a new valuation completed, to determine the pension system's unfunded actuarial accrued liability (UAAL). Then, it will decide what portion of the UAAL will be funded with the POB. In the 1990s, most employers funded the entire UAAL, but for various reasons discussed below, many now tend to finance less than the full amount. Once the POB is sized and sold, the net proceeds are placed in the pension trust fund to be commingled with the other funds, and usually invested according to existing asset allocation guidelines. Thus, the pension fund experiences a rapid increase in assets resulting in a higher funded ratio.

For the POB to generate savings for the employer, the investment return rate on the invested POB proceeds must be greater than the interest cost of the bonds (and ideally equal to, or exceed the pension system's investment return assumption), and the larger the spread between these two rates, the better. The employer, as POB issuer and obligor, would then be projected to achieve lower total pension contributions than it would have if it had not sold the POB.

POB Risks

POB issuers face three principal risks:

- Arbitrage;
- Leverage; and
- Political

Arbitrage

POBs are essentially an arbitrage arrangement, the success of which depends on the premise that the pension trust fund assets (including POB proceeds) will earn on average more than the POBs' interest cost, and hopefully the pension plan's assumed investment return rate (generally about 8%) or better each year for the life of the bonds. If the bonds are sold at an interest cost of 6%, for example, the spread could generate savings if the investment return goals are met over the life of the bonds.

If the POB trust fund earns 8% or more on the bond proceeds, the issuer would pay lower pension-related costs (contributions plus POB interest) than without the POB. However, if the investment return is less than the POB interest cost, the transaction becomes a drag on cash flow since an unfunded actuarial accrued liability could reemerge. If returns are above 6% (as in the example above) but below 8%, the employer would have increasing contribution costs, but would have had them even without the POB.

While certain periods, particularly the late 1990s, produced some impressive investment returns, returns can vary dramatically and may or may not average the investment return assumption or even the POB interest rate cost. For this reason, a POB's full effect is only known at the bonds' final maturity. Many POBs have appeared successful for several years, or even a decade, only to have investment gains eroded upon maturity. Conversely, after poor results in the early years, some POBs achieved projected benefits in the final analysis.

In any event, we do know that even if projections are met on average over the life of the POBs, there will be years of higher returns, and some that are lower (maybe significantly), than the investment hurdle. We do not have to look back very far to see evidence of such swings: in fiscal 2001, the S&P 500 index of domestic equities fell 16%; in 2002, it fell 19%, but in 2003, it fell only 1.6%. These market declines hurt issuers with POBs outstanding: most had to pay increased contribution rates to cover the new actuarial losses and they had the higher debt service costs due to issuing the POB.

Leverage

Adding too much leverage is another risk factor for POB issuers. Borrowing for any purpose increases leverage and fixed costs. While the issuer is substituting one type of long-term liability (POB) for another (pension UAAL), there is a difference. In most cases, bond debt service is a "hard" obligation compared with the "softer" contribution payments used to amortize the UAAL. Bond debt service becomes a fixed cost and must be paid in full and on time or the issue falls into default with wide ramifications. Conversely, employers' contribution payments to a pension trust may be temporarily deferred or reduced without serious negative consequences.

However, risks and opportunities are also associated with "softer" obligations. A soft obligation may be deferred during a temporary period of reduced liquidity resulting from a onetime unexpected expenditure or an unexpected dip in revenues. The obligation may be deferred until fiscal balance is restored to bring payment of the obligation back on schedule, resulting in no credit impact. Unfortunately, soft obligations may also be deferred for political expediency, creating significant credit issues if this deferral is practiced over successive periods. A hard obligation could lead to better long-term fiscal stability if political deferrals are a real risk. Regardless of the political climate, the size of the POB relative to the issuer's total debt structure must be measured in terms of the level of debt service that can be managed if actual future investment returns do not meet the original POB plan projections.

Political

POBs can become a political issue if the debt is sold to the public as a complete solution to the government's pension funding problem. For example, if a POB is issued for the full UAAL, resulting in a 100% funded ratio, and subsequent higher-than-average returns push the ratio to 110% or 120%, political pressure could arise to distribute the so-called excess funding by increasing benefits or decreasing contributions. In fact, in a lower-return environment with declining funding levels over the long term, those systems that have taken the bulk of their excess funding out of their POB structure may see trouble ahead. For example, say the POB issuer described above had average annual investment returns of 10% against its investment assumption of 8%. However, instead of permitting the natural increase in the funded ratio that these conditions would have caused, the issuer managed its funding

ratio, through contribution holidays and benefit improvements, to maintain the ratio at around 100%. If investment returns decline, the issuer may have already reaped all its gains from the transaction structure and be headed for actuarial losses. If actuarial losses are incurred, employer and employee contribution rates will likely increase.

Rating Process

The rating of POBs parallels that of long-term debt with similar security but also considers certain additional analytical factors pertinent to the POB and trust fund. POBs issued to date usually have a GO or appropriation pledge. In our analysis of POBs, we focus on the bonds' effect on the issuer's debt structure and the ability to meet obligations. The financial review includes the impact on both the balance sheet and the operating statement or cash flows. The status of the issuer's pension trust fund on a pro forma basis is also part of the review.

From the balance sheet perspective, we look at how the POB fits into the issuer's total debt structure, including a review of future capital requirements that may require bonding, as well as other long-term liabilities. We look at total debt with and without the POB so as not to penalize an issuer in comparison to another issuer that may have relatively low debt (and no POBs) but sizable unfunded liabilities. We also evaluate the leverage added by the POB to determine if the issue markedly increases hard, fixed costs (bond debt service) in place of a softer, more discretionary obligation. We will also seek to determine if subpar investment returns could put upward pressure on pension contribution rates and whether higher contribution rates, coupled with the POB debt service costs, put the issuer's budget under greater strain. The issuer must also be cognizant of the effect a POB issue may have on statutory debt limits or whether the issuance impedes debt issuance for the capital improvement plan.

From a cash flow standpoint, we review projected debt service and contribution costs, with and without the POB, and the validity of the assumptions, including those for POB interest costs and trust fund investment returns to determine how these projections compare in total and annually.

The spread between interest costs and investment return generates the savings expected from the transaction. The issuer must be able to provide details on the following:

- Magnitude of annual savings and total present value savings.
- Where (in what years) are the savings taken?
- Are the savings front-loaded in an attempt to mask budgetary stress?
- Will any front-loading lead to higher, unsustainable contribution rates in later years?
- Do the potential savings from the POB outweigh the risks involved?

The cash flow analysis is critical to understanding the full impact of the transaction. As part of the POB analysis, we also review the status of the pension trust fund, which receives the bond proceeds:

- What is the statutory relationship between the issuer/employer and the pension fund?
- How have the laws and precedents for contributing affected funding progress, and how do they play into the POB strategy?
- What are the funding goals and how will the POB affect these objectives?

Special rating documentation requirements for POBs

The unique nature of POBs calls for certain additional documentation not normally requested for other types of ratings:

- POB financing plan, including its effect on the overall debt plan;
- Projections of UAAL contributions and debt service with and without the POB;
- Latest pension fund annual report;
- Most recent actuarial valuation and experience studies of the fund; and
- Pension fund's current asset allocation strategy and plan for investing POB proceeds.

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