Spotlight on Governmental Plan Pension Obligation Bonds

A number of state and local governments have turned to pension obligation bonds — issued by the state or local government entity itself — in an effort to shore up the funding status of their retirement plans. Critics see this concept as an investment gamble, and complain that the approach saddles future taxpayers with bond repayment obligations to cover past liabilities. Whether through bond repayments or future contributions, however, state and local governments must find funds to pay promised benefits. Actuarial analyses of likely outcomes can help plan fiduciaries understand the risks of different funding approaches.

Background

In an effort to address large unfunded pension liabilities, many state and local government entities have turned to pension obligation bonds (POBs) to finance promised benefits. POBs are bonds issued by the responsible governing entity, and are typically municipal general obligation bonds backed by the full faith and credit of the issuing municipality. However, because they are characterized as “arbitrage bonds” — bonds issued at a lower interest rate than that obtained on invested securities — the Tax Reform Act of 1986 bars the usual municipal bond federal tax exemption so that coupon rates on POBs trend higher than the typical rate for municipal bonds.

With POBs, funds obtained from the sale of the bonds are deposited in the pension trust. Over time, the governing entity must pay the interest and principal to the bondholders; meanwhile, the trust invests the proceeds and benefits from investment returns with no obligation for the repayment of the amount borrowed. In short, the government entity swaps an obligation to pay future pension contributions for an obligation to pay future interest and principal to bondholders.

The goal in issuing POBs is to invest in assets that will earn a greater rate than what is paid to bondholders — which, in turn, drives down the future pension contribution obligation. If the funds deposited in the trust ultimately earn the same rate of income paid on the bonds, the exercise is simply a “wash.”

There have been several thousand POB offerings since the city of Oakland, California debuted the bonds in 1985. Some POBs have
successfully generated excess earnings. Others traded into the 2001 and 2008 downturns, leaving the plan sponsors with large future pension contribution obligations to make up for the losses.

**Unhappy Bondholders**

As reported in our February 3, 2015 *For Your Information*, recent municipal bankruptcies have resulted in defaults on municipal bonds that left bondholders with huge losses. While some argued that bond obligations should have stood on par with outstanding pension liabilities, pensions won out at the end of the day. Here’s how some of these municipalities paid off on bond versus pension obligations:

<table>
<thead>
<tr>
<th>Municipality</th>
<th>Pennies per dollar to uninsured bondholders</th>
<th>Pension cut for retirees</th>
</tr>
</thead>
<tbody>
<tr>
<td>City of San Bernardino, Calif</td>
<td>1</td>
<td>None</td>
</tr>
<tr>
<td>Stockton, Calif</td>
<td>Between 12-41</td>
<td>None</td>
</tr>
<tr>
<td>Detroit, Michigan</td>
<td>Between 26-66</td>
<td>Up to 4.5% and COLA cutbacks</td>
</tr>
</tbody>
</table>

Although these defaulting municipalities ended up with improved ratings after clearing out liabilities, other struggling municipalities received depressed grades from rating agencies because of increased sensitivity to huge unfunded pension liabilities. Given how poorly bond investors fared vis-à-vis retirees in the recent municipal bankruptcy context, they are increasingly wary of loaning money to cash-strapped municipalities. The dearth of municipal bond insurers only adds to bond investors’ risk; about half the muni market was insured in years past, but few insurers remain today.

**More Costly Borrowing**

While not all bond offerings affected by the municipal defaults were POBs, investors have become acutely aware that buying any type of municipal bond may be a lot riskier than previously believed. This view, in turn, may make it more difficult for a government entity to borrow money at a reasonable rate — for pension funding or any other needs. It could also pressure municipal governments to increase taxes to cover the demand for direct pension contributions and to pay for necessary municipal services.

**Useful at Higher Rates?**

If investment assets can generate returns in excess of the — now possibly inflated — cost of the bond, does it make sense to push forward with a new set of POBs? The math behind POBs includes an assumption that the plan will generate income at the assumed investment return rate used for GASB valuation purposes. If the market rate on a bond offering is less than the GASB rate, assets generated by the POBs create actuarial gains for the fund where investments actually yield more than the GASB rate. Conversely, if the actual yield is less than the GASB rate, ultimately those shortfalls need to be made up with new money — though there is still a benefit to the sponsoring government if the rate earned is greater than what is being paid to bondholders. So with the median GASB investment return assumption at 7.75% according to data compiled by NASRA (National Association of State
Retirement Administrators), and the typical interest rate owed on pension obligation bonds standing at about 5.5%, there is still a margin of available arbitrage.

However, the GFAO (Government Finance Officers Association) strongly recommends against using POBs due to their speculative nature. In addition to the possibility of earnings on the invested funds falling short of borrowing costs, this group points out that these bonds are complex instruments that may use guaranteed investment contracts, swaps or derivatives — complicated financial tools that must be intensively scrutinized to identify counterparty, credit and interest rate risk. The bonds are also faulted for eating into debt capacity that could be used for other purposes, and for drawing negative rating agency reactions.

**Actuarial Analysis**

It is simplistic to consider only the difference between the fixed rate owed on the bond and the projected investment return rate. Investment rates are unlikely to be uniform over time, particularly for equity investments. One year, investment returns might hit 20% or more, while in another year investments yield just 2% — and in the next post a loss of 10%. A huge influx of cash — such as with a bond issuance — is particularly susceptible to short-term rate experience. A 30% decline just after infusing millions of dollars into the fund presents the same problem as a 30% decline for an individual who is about to retire and cannot rebuild retirement savings. While the municipal entity can add to the fund, there is competition for current dollars from the obligation to pay off the debt.

Analyzing the wisdom of borrowing to improve the plan’s funding ratio entails the use of stochastic forecasts — the various permutations of possible results based on large numbers of possible scenarios. For example, the simulation could reveal that there is a 75% chance of a savings over time versus a 25% chance of being in worse financial shape — the numbers will vary based on the metrics considered and the specifics of the plan. It is for plan fiduciaries to decide whether the odds of success are worth the threat of downside risk.

**In Closing**

Some observers criticize the idea of borrowing to shore up available trust assets because the bond repayment obligation saddles future taxpayers — but unfunded liability also saddles future taxpayers with the cost of paying promised benefits. One way or the other, funds must be produced to satisfy those obligations. Careful financial analysis can help to assess the pros and cons of funding now versus funding later.
Authors
David L. Driscoll, FSA, MAAA, EA, FCA
Marjorie Martin, FSPA, EA, MAAA
Julia Zuckerman, JD

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