

Pension Obligation Bonds:

*Tricks, Tips and Traps – What Every
Savvy Issuer Ought to Know*

What Are “Pension Obligation Bonds?”

- ❑ Debt securities used to fund “unfunded accrued actuarial liabilities” in public pension plans.
- ❑ Almost always issued as taxable debt.
- ❑ Can be issued as fixed rate, fixed term securities, or as variable rate, fixed term securities.
- ❑ Typical security is the issuer’s general fund pledge.

Past Issuers of POBs

\$11.8 billion
total issuance
since 1986

Sale Date	Issuer	Par Amount (\$MM)	Sale Date	Issuer	Par Amount (\$MM)
12/04/86	Los Angeles County	461.493	11/19/97	Imperial County	35.175
10/20/93	Sonoma County	97.400	03/12/98	Fresno County	184.910
02/03/94	San Diego County	430.430	04/22/98	City of Bell	1.870
02/15/94	Contra Costa County	337.365	05/19/98	City of Berkeley	12.415
03/17/94	City of Fresno	245.555	06/24/98	Trinity County	9.140
04/21/94	City of Chula Vista	16.787	02/03/99	Merced County	63.070
09/23/94	Orange County	110.200	07/29/99	City of Pasadena	101.940
09/23/94	Orange County	209.840	11/03/99	City of Richmond	36.280
10/13/94	Los Angeles County	248.395	07/11/00	City of Fresno	211.350
10/12/94	Los Angeles County	600.000	03/08/01	Contra Costa County	107.005
10/13/94	Los Angeles County	1116.835	06/05/01	Imperial Irrigation District	75.000
04/12/95	Alameda County	310.150	06/13/01	City of South Gate	8.500
06/22/95	Sacramento County	134.000	10/03/01	City of Oakland	195.639
06/22/95	Sacramento County	404.060	01/23/02	City of Fresno	205.335
07/28/95	City of Santa Rosa	8.665	03/13/02	Fresno County	117.055
09/13/95	Stanislaus County	108.970	08/09/02	City of Long Beach	43.950
10/19/95	Los Angeles County	600.000	08/09/02	City of Long Beach	44.000
10/25/95	City of Long Beach	108.635	09/06/02	Imperial County	33.265
11/10/95	Kern County	227.818	09/17/02	San Diego County	737.340
11/22/95	San Bernardino County	420.527	12/12/02	Mendocino County	91.945
11/30/95	Ventura County	154.510	04/23/03	Contra Costa County	322.710
04/24/96	Los Angeles County	327.400	05/07/03	Marin County	112.805
06/06/96	Orange County	121.680	05/14/03	Sonoma County	231.200
12/09/96	Mendocino County	30.720	05/15/03	Kern County	238.177
12/12/96	Alameda County	306.863	06/26/03	San Luis Obispo County	137.194
01/07/97	Orange County	136.923	07/15/03	Sacramento County	152.321
02/14/97	City of Oakland	436.289	05/01/02	Contra Costa County	200.000
05/15/97	Tulare County	41.460	07/01/04	Sacramento County	400.000

First, Some Background

□ Pension plans are “systems” of cash flows:

◆ Cash flows in, in the form of:

- Earnings paid in cash (or realized) on investment assets
- Contributions made by the employer

◆ Cash flows out, in the form of:

- Losses realized on investment assets
- Payments made to plan beneficiaries

Pay attention to the difference between “realized” and “paper” gains and losses

□ Pension plans may be:

- ◆ Defined benefit plans, or
- ◆ Defined contribution plans

Defined Benefit Plans – In General

- Defined benefit plans generally have common characteristics:
 - ◆ Plan participants can gauge how much, and when, they are likely to receive benefits from the plan, based on their (or their employer's) past actions
 - ◆ Plan obligations are met through a combination of
 - Timely contributions from the employer, *and*
 - Investment earnings, *and*
 - Correct assumptions about how, and when, plan participants will make their individual financial demands on the plan's assets – the “actuarial liability”

How It's Supposed to Work

- ❑ Employers contribute on a regular (and rhythmic) basis to the plan
- ❑ Plan assets are invested in securities (usually heavily in equity securities) designed to meet both growth and liquidity requirements
- ❑ Plan participants retire, then gradually draw down their “defined benefits” over their retirement years
- ❑ Plan sponsor redeems or sells assets to meet these demands

What Can Go Wrong?

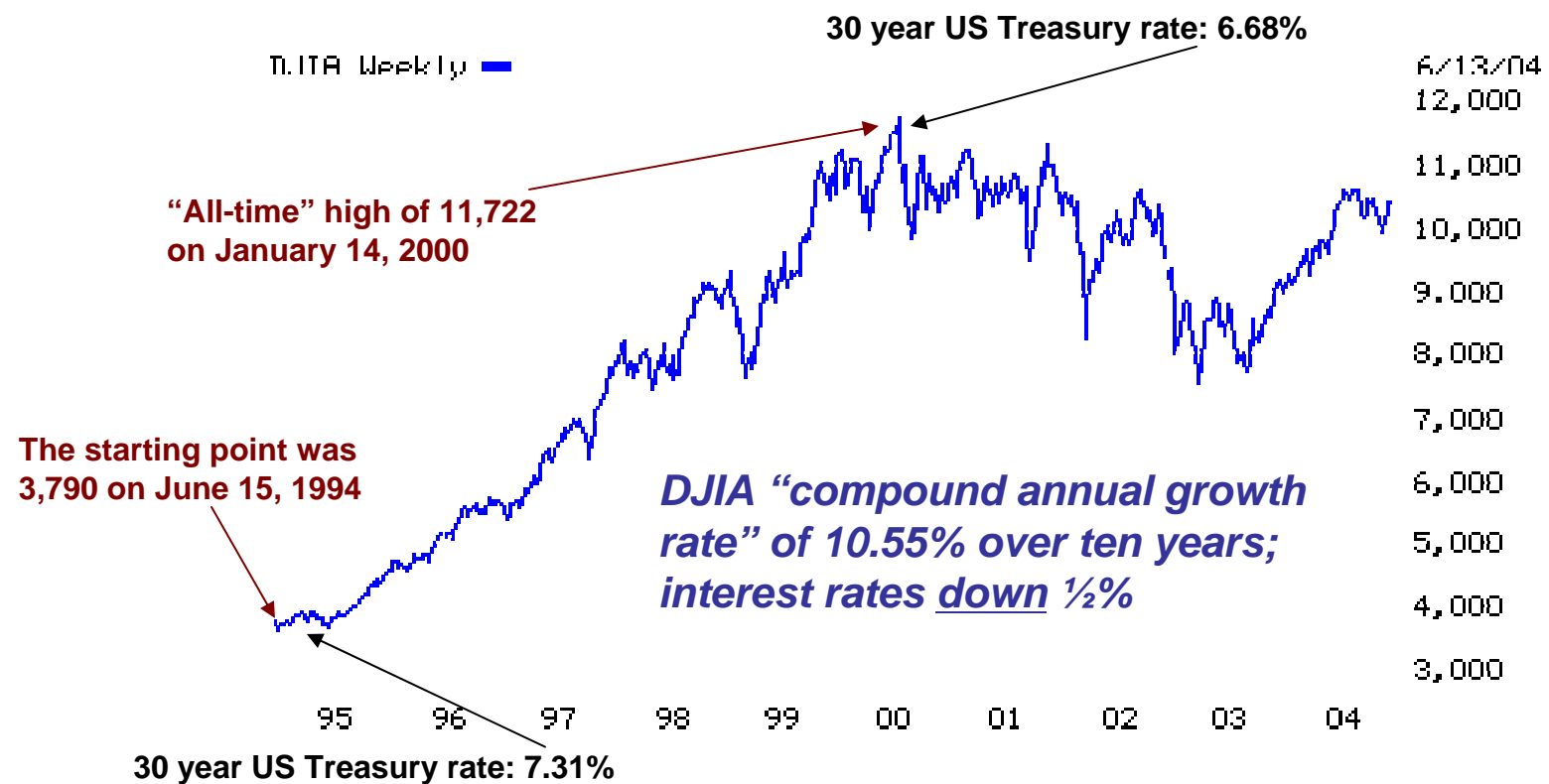
- ❑ Everything!
- ❑ Employers contributions may be rhythmic, but they are sometimes irregular (more on this later)
- ❑ Investment earnings are attained over time, and the investment securities must be sold in order to “lock-in” the investment gains that are presumably made over time
- ❑ Plan participants may change their behaviors, or life expectancy without notice to the plan!

It's Not the "Timing" of the Market . . . It's the "Time In the Market" That Counts

- Defined benefit plans usually have some basic underlying assumptions:
- Rate of investment earnings, annualized
- Proportion of the employer's payroll costs that are periodically deposited
- Age at which the "typical" participant will retire
- Age at which the participant dies (planned or not)
- As usual, the "devil" is in the assumptions
- Let's consider three recent periods . . .

Why Are POBs “Hot” Right Now?

- During the 1990s, investment returns were at historic levels – consider the performance of the Dow Jones Industrials over the past ten years shown below – up almost 8,000 points!!!



Now, Look at “Just” the Past Three Years

- Your “point of view” depends on “where you sit” – the same index over only the past three years looks very different – down over 350 points.



Moral of the Story

- ❑ Had you borrowed money in June 1994 at 7.31%, and invested it in the Dow Jones stocks, you'd look like a real hero
 - ◆ Money cost would be less than “compounded annual growth rate” of the investment securities of 10.55%, a “spread” of more than 3%
- ❑ Conversely, had you borrowed money in June 2001 at 5 ¾%, and invested it in the same stocks, you'd look a little foolish
 - ◆ Money cost would be significantly more than the growth rate on the investment securities, a “negative” spread of -1.12%
- ❑ Note that had you done this trade in September 2001, the results would be vastly different – more on that later

Sound Familiar?

- ❑ Someone says: “We are already well funded, so we can ‘skip’ this year’s contribution and save the budget.”
- ❑ Plan beneficiaries say, “It’s our money, and your earnings have been robust, so give us ‘3 @ 50’ and we’ll be happy.”
- ❑ Wall Street says: “Interest rates are low, so you can borrow now and invest with higher returns – it’s a ‘no-brainer.’”
- ❑ The plan manager says: “The assumptions have changed.”

Risk Arbitrage

□ Defined:

- ◆ The differential in earnings obtained by investing in one market, and taking an opposite position in another
- ◆ Example: borrow money at short term rates and invest it at long term rates (ring a bell?)
- ◆ Example: borrow money at a fixed rate of interest, invest in securities that are projected to earn more (borrow money at today's low rates, say 6%, invest in the pension fund assets at, say 8 1/4%)

Considerations

- Risk arbitrage is called that name for a reason
- No free lunch
- Differentiate between problems brought on by market under-performance and those that are “self-inflicted” – the responses may not be identical
- Observe the rule of timing vs. time of (the 9/11 phenomenon)
- Use GFOA’s recommended practice as a starting point
- Get good, qualified help with the matter

Specific Considerations for You

- Ensure that the amortization of the debt is consistent with the term the plan allows for making up unfunded liabilities
- Distinguish between “market” funding levels and moving average valuation of assets – they affect the size of the POB
- Is the unfunded liability “frozen” or is it subject to future movement?
- Explore all options, including re-scheduling payments (“fresh start”)
- Don’t defer principal to obtain budgetary relief
- Pay attention to the discount rate used for measuring present value
- Understand the difference between “hard” obligations (like POBs) and “soft” obligations, such as ongoing pension contributions
- Understand that the POB won’t eliminate the possibility of future unfunded liabilities
- “Actual” debt (POBs) may diminish debt capacity levels and/or affect credit rating strength
- Establish a process for regular review of progress – the results don’t come in until all the employees are retired and the bonds are as well!

Additional Information

- ❑ Financing Retirement Systems Benefits, Richard G. Roeder, Public Employee Retirement Series, GFOA, 1987
- ❑ “Pension Obligation Bonds: Practices and Perspectives,” Government Finance Review, GFOA, December 1996
- ❑ GFOA Recommended Practice “Evaluating the Use of Pension Obligation Bonds” (2004) (in review; expect publication this summer)
- ❑ There are very helpful resources available on the GFOA’s web site @ <http://www.gfoa.org/services/rp/corba.shtml> (*for pension matters*) and <http://www.gfoa.org/services/rp/debt.shtml> (*for debt considerations*)