A Fresh Look at Pension Obligation Bonds

Leverage Your Understanding and Know Your Risks

By any measure, 2020 was an extraordinary year, characterized by health, social, economic and political crises. From the perspective of public sector pensions, it's also notable for the resurgence of interest in pension obligation bonds as a potential means of plan financing.

In California alone, the number of pension obligation bonds issued as of October 1, 2020 was three times 2019 levels and seven times 2018 levels, according to an S&P Global Ratings report. Nationwide, over those three years, pension obligation bonds were responsible for an inflow of assets into pension systems of nearly $3 billion.

In this publication, we note the factors behind the fresh appeal of pension obligation bonds before discussing their potential pitfalls: hidden costs and risks.

As a trusted advisor to many of these systems and their plan sponsors across the United States, Segal believes that it's crucial to approach the consideration of pension obligation bonds with understanding, perception and caution.

The basics

When a state or local government seeks to raise money for projects or operations, one instrument at their disposal is the issuance of a bond (debt) to help finance those objectives. Pension obligation bonds (POBs) are a particular kind of taxable bond where the proceeds are dedicated entirely to the government's pension obligations. The interest charged on these bonds, which determines the cost to the issuer, is related to the credit rating of the municipality, along with other market conditions and factors.

When a government issues a POB, it is taking on fixed debt service to cover some or all of its **current** pension unfunded liabilities, which are variable over time. The goal is that the return on the proceeds that they have invested in the pension system will be higher than the interest cost on the related debt over the long run. When that happens, the issuance is financially favorable.

While there is some validity to this sentiment on the surface, we intend to illuminate some of the considerations and risks associated with POBs that may not be as obvious at first glance.

The resurgence of interest in POBs

We believe there are three primary reasons why there is a renewed focus on POBs from the public finance community and the governments that they serve:

- The difference between current low interest rates a government can obtain in the market from bonding and the rate of return pension plans expect to earn from their invested assets
- The combined effects of COVID-19 related economic disruption and increasing pension costs
- A diminished recollection of severe economic losses on some prior POB issuances

Interest rates and rates of return

Interest rates have been held at historically — many would argue artificially — low levels for some time now, without any indication of upward movement. Public pension plans' rates of return have also declined, but not as significantly, as pension plan assets have shifted away from low-returning fixed income investments into more equities and alternative investments.

Consequently, the spread between the interest on POBs that a government would have to pay and the return on pension investments that the government hopes to capitalize on has grown. That difference makes POBs look more favorable than before. This apparent opportunity was especially stark with the depressed market prices in March and April of 2020.

The economic impact of COVID-19

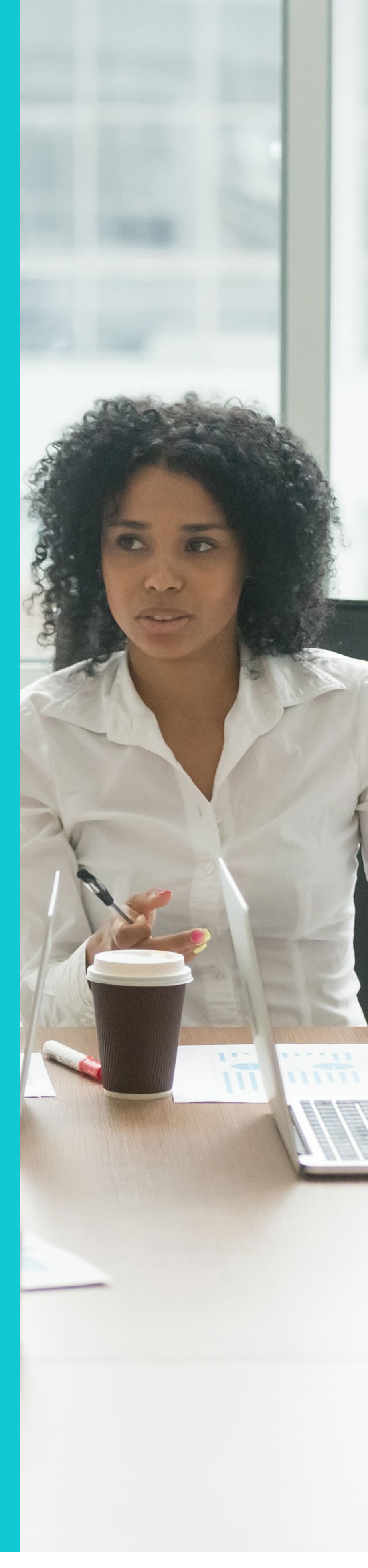
Many state and local governments have seen their revenues decline significantly. This has exerted an additional squeeze on expenditures.

Pension costs have generally risen over the last decade as a percentage of total governmental expenditures. Pension contributions increased in the wake of both The Great Recession and the subsequent movement towards more conservative actuarial assumptions. POBs offer the potential to stay or abate these growing contributions at what appears to be little risk.

A matter of time

History can remind us of high-profile municipalities offering POBs at the wrong time — right before a market crash. Those issuers lost additional pension assets, had to pay higher debt service and were faced with excessively high total costs. However, with the steady market run-up of the last decade, these horror stories may have become a distant memory.

Additionally, the Government Finance Officers Association (GFOA) issued a formal advisory against POBs in early 2015. In the next few years, POB issuance was rare. However since it has been over five years since that advisory, some may view the GFOA advisory as less relevant or somewhat out of date.



Blinders off

POBs have the potential to carry hidden costs and hidden risks. While this does not make them off limits in every possible circumstance, it does demand that officials of any government considering using them go into the process with eyes wide open.

In this section, we present an overview of important analytical considerations and potential pitfalls that we maintain require attention and review before any POB issuance.

Imprudent structure

POBs can be built in a variety of ways based on components such as payment structure, interest structure and total repayment period. Debt service that starts as interest-only payments or otherwise defers costs can lead to a back-loaded amortization schedule that pushes the cost burden onto future taxpayers.

POB repayment periods that extend beyond the amortization of the unfunded liability that they are paying off are another way to "create" savings early on, but increase costs overall.

Complex structure

POBs can incorporate complex structures that include market instruments like swaps and derivatives. These products obscure total cost and make objective financial analysis elusive. They also introduce additional forms of market risk, depending on the financial instruments used.

In our view, POBs carry plenty of risk even without the use of these complex structures.

Speculative leverage

Inherently, POBs are governments taking on debt to invest in the market (through their pension systems). There are arguments on both sides as to whether this is appropriate for governments.

Either way, there is a real chance that the investments do not perform as expected. If that happens, the POB issuer will face a higher combination of pension contributions and debt service.

Taking on fixed-debt service to invest in variable pension system assets should never be considered an opportunity for no cost arbitrage.

Elevated volatility

There's a practical way to evaluate how sensitive pension contributions are to investment returns: It involves considering the "asset volatility ratio" (AVR), a government's pension assets divided by their payroll.

For most plans, any unexpected investment experience will be treated as a gain or loss and will be processed through a government's payroll to adjust future contributions (as a percentage of payroll). The higher the AVR, the more sensitive contribution rates will be to changes in assets.

POBs boost the AVR while at the same time adding fixed debt service. This leads to total costs that may be significantly more volatile than before the issuance of the POBs.

Given that we are in an environment of great financial uncertainty and potential volatility in the market, governments need to fully understand the implications of POBs on future changes in contribution rates and total costs.

Volatility drag

When investments experience swings in returns, that volatility creates a drag on total fund performance. This is caused by the compounding of investment returns over time.

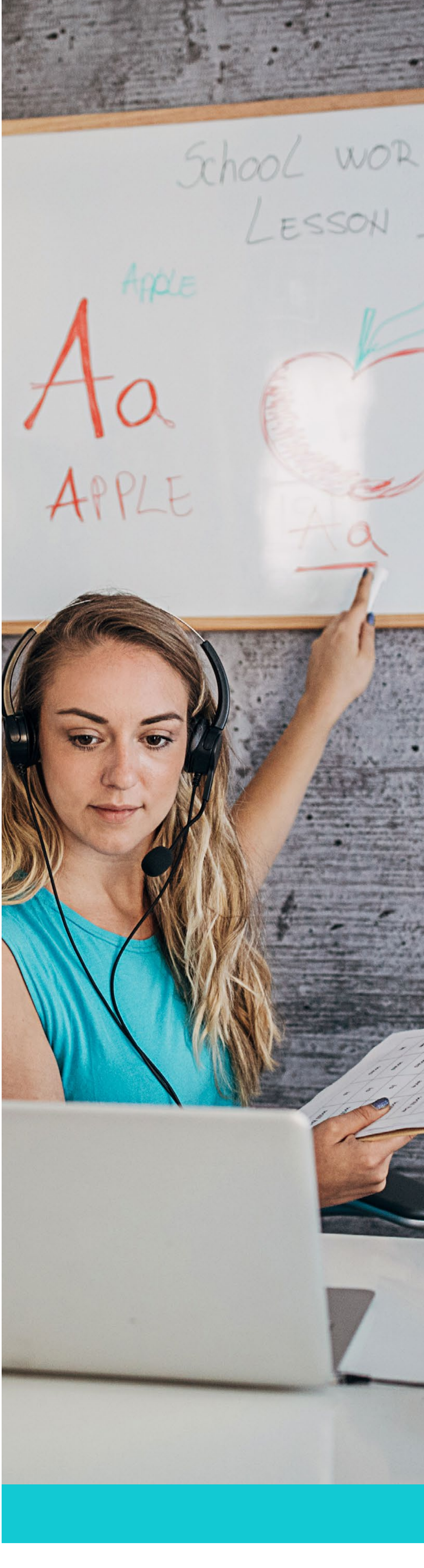
To illustrate this, consider a simple two-year investment return scenario. In year one, the markets crash by 20 percent, leaving assets at 80 percent of their original value. That means assets must grow by 25 percent in year two, not 20 percent, just to reach the starting value.

POBs increase the AVR, leaving more dollars exposed to this volatility drag while simultaneously increasing fixed costs through debt service.

Timing vulnerability

In the years immediately following the issuance of a POB, the profitability is particularly sensitive to experience in the market. This is a result of the aforementioned immediate boost in assets and AVR, which enhances the potential for volatility drag on actual dollars invested. Any adverse experience will have an immediate and compounding effect going forward.

That effect is particularly dangerous for governments in a vulnerable financial position, which may be the case for those considering POBs.



Are POBs pension "reform"?

Advocates of POBs sometimes characterize their issuance as pension reform in response to growing pension costs. This is severely misleading. Taking on debt to put money towards pension liabilities is not pension reform unless accompanied by other corrective measures, including a commitment to establish proper funding protocols for future years.

If unfunded liabilities have expanded significantly in recent history, it is necessary to evaluate and understand exactly what factors are the primary causes. In some cases, strengthening assumptions and funding methods have led to higher measured unfunded liabilities and higher costs in the short term, but a much more sustainable and stable path going forward. In other cases, the continued existence of aggressive assumptions or ineffective funding policies (and thus, ineffective contributions) have inhibited funding progress and compounded costs.

In the latter case, POBs do nothing to mitigate or fix these obstacles to prudent funding. Governments that issue POBs in such a position may well find the new infusion of cash akin to putting money in a pocket with holes in it.

Transparency is key

Undeniably, POBs appear more advantageous today than they have in the past, especially in light of historically low interest rates. As part of an overall funding strategy that includes funding discipline and plan review, POBs may have a place. However, we maintain that POBs have the potential to carry hidden costs and hidden risks that can affect the financial profile of both a government and its pension plan in multiple ways, both intended and unintended.

It is vital that any government considering the issuance of POBs thoroughly explore the analytical considerations laid out here so that any decisions made will be both fully informed and fully aligned with the government's long-term financial objectives.

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