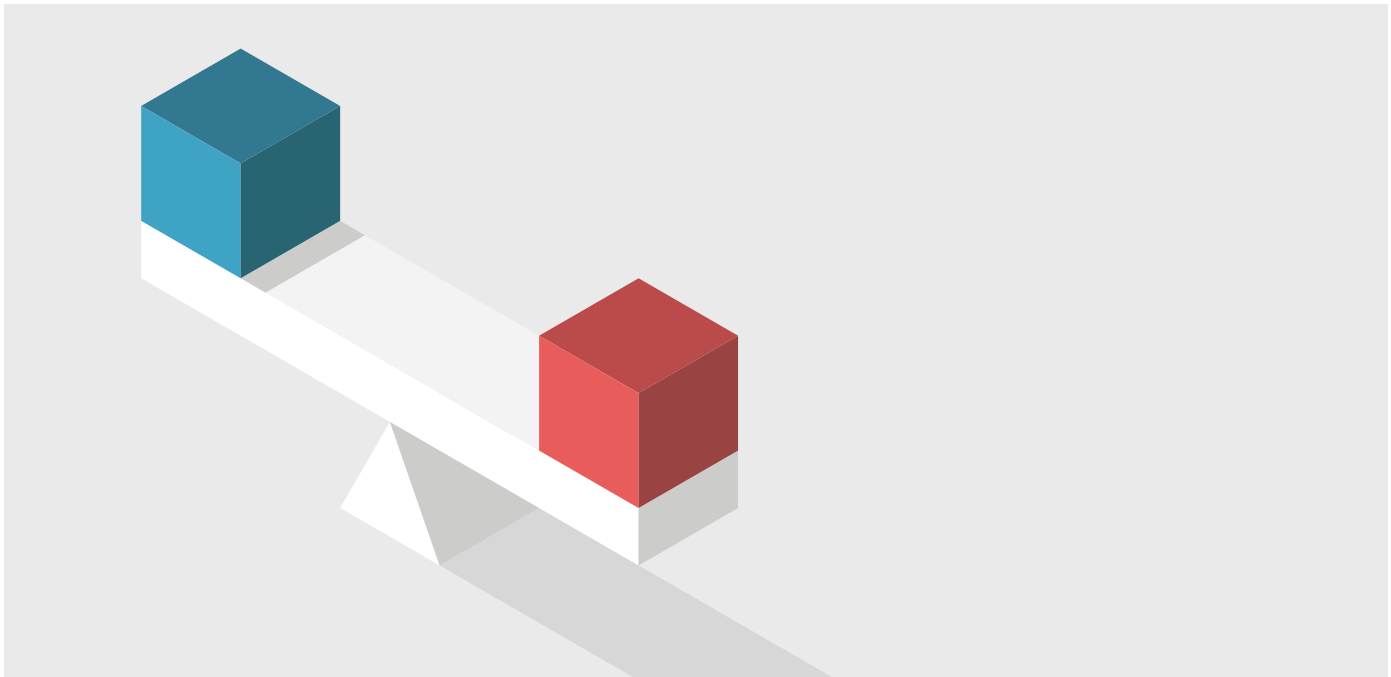




Point / Counterpoint

Pension Obligation Bonds: Yes or No?

Pension obligation bonds (POBs) are taxable bonds that some state and local governments have issued as part of an overall strategy to fund the unfunded portion of their pension liabilities by creating debt. When economic times are bad, governments sometimes consider issuing POBs to reduce their fiscal stress, but the practice is controversial. The use of POBs rests on the assumption that the bond proceeds, when invested with pension assets in higher-yielding asset classes, will be able to achieve a rate of return that is greater than the interest rate owed over the term of the bonds. However, POBs involve considerable investment risk, making this goal very speculative.

For these reasons, GFOA President and Hanover County Public Schools Assistant Superintendent for Business and Operations **Terry Stone** sticks with GFOA's position that state and local governments should not issue POBs. On the other hand, **Girard Miller**, former chief investment officer of the Orange County Employees Retirement System with a career in public finance spanning 30+ years, suggests that, at certain times and under certain economic circumstances, a pension fund can reasonably consider POBs as part of its overall strategy.



Terry Stone is GFOA president and Hanover County Public Schools assistant superintendent for business and operations.



Girard Miller, CFA, is a retired investment professional, an honorary lifetime member of GFOA, and no longer affiliated with any financial services firms.

POINT

Don't Do It

By Terry Stone

Governments don't always fully understand how much of a gamble POBs are, which is why GFOA published its *Pension Obligation Bonds* advisory (available at gfoa.org) years ago, when the strategy saw a resurgence after the 2008 financial crisis. POBs are based on market timing, which makes them less of a strategy and more of a gamble. There's an excellent chance that investments made with the POB won't achieve the targeted rate of return, which burdens the issuer with both the debt service requirements of the taxable bonds and the unfunded pension liabilities that remain unmet because the investment portfolio did not perform as anticipated.

Something else to consider: "The jurisdictions that issue POBs tend to be financially the most vulnerable, with little control over the timing," according to an often-cited study by the Center for Retirement Research at Boston College. And POBs have been involved in municipal bankruptcies including the City of Detroit, Michigan, and the cities of Stockton and San Bernardino, both in California.

Other reasons to avoid POBs include these:

- The sale of POBs does not constitute a true solution to an underfunded pension plan. After bonds are sold, a government still faces the potential for unfunded liabilities in the future caused by lower-than-expected investment returns, changes in benefit levels, shifts in employee demographics, or other factors that were not fully anticipated or expected when the bonds were issued.
- Issuing taxable debt to fund the pension liability increases the jurisdiction's bonded debt burden and potentially uses up debt capacity that could be used for other purposes—*like infrastructure*.
- In addition, taxable debt is typically issued without call options or with "make-whole" calls, which can make it more difficult and costly to refund or restructure than traditional tax-exempt debt.

COUNTERPOINT

Don't Throw the Baby Out with the Bathwater!

By Girard Miller

Here's the devil's advocate position: Brainless POBs are unduly risky 95 percent of the time. But once in a blue moon, POBs can work. I'm going to describe the conditions necessary for timely and prudent implementation of a POB (and OPEB-OB "benefit bonds") strategy in a "blue moon" phase. And I began writing this counterpoint on March 30, knowing that it wouldn't be mailed to readers until June, at which point the moon might already be green if not yellow, as it has become.

Investment bankers and money managers love to pitch POBs. They make money selling bonds and investing proceeds. For them, every moon is a full moon. Their "Monte Carlo" simulations always work, deceptively, because they conveniently assume that stocks appreciate upward randomly as their simulations suggest. That ignores market and economic cycles that immediately throw naïve issuers underwater in the next recession.

POBs are essentially a *risk* arbitrage between low-cost taxable municipal interest rates and the *properly probable* long-term rate of returns on riskier equity investments. This really has little to do with actuarial assumptions, as many opponents and advocates misunderstand: It's actually about the long-term "capital markets line" (from CAPM), which rewards equity beta. Capitalism works only if risk is rewarded: Anybody who can't fathom that should avoid POBs.

Successful POB and OPEB-OB implementation requires the following preconditions and gestalt, and is prone to disappoint otherwise:

- Sufficient sophistication in the finance office, and strong rapport with elected officials and pension trustees. This complex process requires institutional agility, trust and a common

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- The interest cost of pension obligation bonds is considerable, particularly given their taxable status. The short-term benefits of the proceeds versus this long-term commitment to repaying proceeds—plus interest—is not always well-understood or articulated when considering annual debt service costs.
- The way POBs are structured frequently defers the principal payments or extends repayment over a period longer than the actuarial amortization period, thereby increasing the sponsor's overall costs over an extended period of time.
- POBs undermine the concept of intergenerational equity, continually kicking the can for current pension costs down to future taxpayers and further limiting the government's ability to provide services.
- Rating agencies may view the proposed issuance of POBs as a credit negative, particularly if the issuance is not part of a more comprehensive plan to address pension funding shortfalls. And the idea that the immediate threat has been taken care of can lead to a feeling of being “off the hook,” which isn't conducive to reform.
- A credit rating downgrade will increase future borrowing costs regardless of whether the downgrade stems from the issuance of POBs directly, without pension system changes, or the increased debt burden of POBs.
- The issuance of POBs can gloss over important issues related to sustainability of benefits and the

amount of employee contributions that will still cause funding issues even after the POB proceeds are gone.

- POBs are complex instruments that carry considerable risk. POB structures may incorporate the use of guaranteed investment contracts, swaps, or derivatives, which must be intensively scrutinized, as these embedded products can introduce counterparty risk, credit risk, and interest rate risk.

From a purely financial perspective, issuing pension obligation bonds can produce savings for a government if the interest rate paid on the bonds is less than the rate of return earned on proceeds placed in the pension plan. But even if a government were to achieve positive net returns on a POB, the issuer is likely to face inflexible POB debt service requirements along with increasing unfunded pension liability payments. Keep in mind that these bonds have a 30-year life to ‘solve’ a problem that reaches its peak in a considerably shorter time frame. Pension obligation bonds extend the risk for an even longer term while creating the potential for even more issues related to debt capacity and interest costs.

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purpose—which is not always common in many governments.

- Advance planning. Nobody should spring a POB on unprepared governing bodies. In a perfect world, most POBs would be calmly pre-authorized when the moon is yellow (normal markets), not blue (recessions), so that the trigger is pulled for both the bond issuance and the investment of proceeds *only* when stock market indexes are depressed dramatically from prior levels. This way, there are no surprises and the “deal terms” are well understood and vetted.
- Researched, disciplined implementation. Wait (to borrow *and* invest) for a recession with markets down at least 25-30 percent and preferably more, not just a stock market correction. Since WWII, this precondition typically avoided losses in the next cycle. Don’t naively rely on low interest rates as the rationale. Respecting the cyclical path of future equity appreciation is what determines success, coupled with the entire system’s fortitude to weather the next market down-turn.

- POB windows are typically short-lived. Abort a pending bond issue if equity markets rally too quickly. By presstime, stocks had already rebounded from their “C-19 POB trigger point” last March, to a level where historical data say a deal would not be viable. That’s why standing authorizations are superior than belated efforts to catch a market bottom.
- Don’t sell taxable bonds to buy taxable bonds. Simply invest all proceeds in a low-cost equity index. There is nothing to gain from investing a chunk of POB proceeds in the bond market; which raises fees unnecessarily. Scale the deal to 50-70 percent of the unfunded actuarial liability (at current market values) and let equity appreciation over time close the funding gap. This may require establishing a separate trust fund if pension trustees and their consultants only know one way to invest; their traditional asset mix will be sub-optimal. “Alpha” manager fees are a deadweight drag on the POB’s risk arbitrage.
- Expect that markets can perversely decline after placing investments. Nobody can time the market perfectly, so the strategy must rely on entry points that are historically sensible from a long-term investment standpoint, and be able to ride out the volatility in coming months.
- OPEB bonds are worthwhile for employers that have over-relied on pay-as-you-go funding; they establish a systematic intergenerational funding plan. Even if it’s too late for precision POBs, it may still be timely for OPEB-OBs if the C-19 moon is still green (recovery) but not yet yellow.
- Finally, no POB is foolproof and risk-free. Global wars and depressions do happen, as the 1930s taught us. Never forget that luck is not a strategy: Monte Carlo is a casino.

Stock market indexes have recovered half or more their March losses, as this article is being edited. The POB window is once again closed for now, so only a second bear-market leg downward would re-institute viability of the strategy this year. 🚫

Tell Us Your Side

Local governments face risks and reward when it comes to POBs. In this edition of *Point/Counterpoint*, we’ve heard from members on both the pro and con sides.

Now it’s your turn. What do you think? Are you pro-POB? Or are you opposed? What successes or failures have you seen? Contribute to our digital debate by commenting at gfoa.org/gfr/debate.