

Pension Obligation Bonds—Are They a Good Move for Alaska?

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The Department of Revenue is considering the sale of pension obligation bonds as a means for the State to reduce annual expenditures of general funds. Although a bond sale can occur without legislative approval, the department intends to discuss the sale of bonds with legislative leaders. Legislative approval is crucial because debt service would require annual appropriations. This paper is intended to provide information to help legislators evaluate the potential sale of bonds.

Pension Obligation Bonds (POBs) are bonds that can be issued by state or local governments. Although bond proceeds are deposited in, and invested by, retirement trust accounts, the government is responsible for paying debt service on the bonds. There is no doubt that cash infusions from POBs (or any other source) always improve the financial health of retirement systems; the question is whether or not a government that issues POBs will be better off.

Proponents (and bond sellers) point out the following advantages of POBs:

1. Infusing bond proceeds into retirement trust funds increases the funding ratio—the ratio of assets to liabilities—and can allow participating employers to avoid reporting increased liabilities on their financial statements and/or paying higher contribution rates.
2. The interest rate on POBs—between 5% and 5.5% in the current market—all but guarantee financial gain for the issuer because the investment earnings on the bond proceeds—assumed to be 8% for Alaska plans—exceed the debt service on the POBs. In short, the government can reduce net expenditures because the debt service payments on the POBs will be more than offset by reduced contributions to the retirement plan.

Regarding the first point, Alaska state and municipal governments are now subject to pension reporting standards recently imposed by GASB (the Government Accounting Standards Board).¹ By limiting the rate of return on investments that poorly funded pension systems can use to project the future value of assets, GASB reporting

¹ New (FY14 and FY15) GASB standards no longer provide guidance on calculating the ARC (the actuarially determined Annual Required Contribution). Traditionally, payment of the full ARC has been a critical measure of retirement system health; by providing a clear path to eliminate unfunded liability, the ARC offers an easy way to determine whether pension obligations are being appropriately funded. Alaska—and other public retirement plan sponsors—used the ARC not only to budget pension plan contribution rates, but also to prepare financial statements. GASB has severed the relationship between pension accounting and pension funding.

Although not required to do so, Alaska continues to calculate the ARC (which will be reported to the legislature during the FY17 budget process).

requirements can make under-funded pension plans appear even less healthy than they looked with higher projected rates of return.

More to the point, a cash infusion from POBs improves the health of a pension plan. If the improvement is sufficient to avoid reducing the assumed rate of return on investments, financial statements will “look better” and increases in contribution rates can be mitigated or eliminated (at least temporarily). In this case, POBs can relieve budgetary pressure.

However, Alaska’s two primary public retirement plans do not fall into the “poorly funded” category. The funding ratios for the Public Employees Retirement System (PERS) and the Teachers Retirement System (TRS) are about 75% and 80%, respectively.² Alaska’s view of POBs should depend on how the bonds affect the real world (as opposed to how they affect the accounting world).

Discussion of the second point is far more complicated. Some issues to consider are listed below:

Some people refer to the difference in the cost of borrowing and the return on borrowed money as “arbitrage”. That term is incorrectly applied to POBs because arbitrage refers to risk-free transactions. POBs carry substantial risk; they exchange the “soft liability” of unfunded pension liability for the “hard liability” of debt service with no guarantee that earnings on POB proceeds will exceed debt service costs.³ The state must pay debt service on POBs even if earnings on POB proceeds are less than interest costs on POBs.

A 5.5% cost versus an 8% return may not be a proper comparison. The 8% return on pension fund investments is a target return, not a guaranteed return. The target rate is arguably too high, especially if declining contributions (due to lower rates attributable to POBs) and higher benefit payments (as employees retire) will exert liquidity pressure that

² Alaska’s funding ratios rank us mid-pack among other government pension plans. Unlike most states, Alaska includes the cost of retiree health benefits in its funding ratios. With GASB rule changes that force reporting of health costs, Alaska’s pension plans will appear much healthier relative to other government plans.

³ Pension liability is sometimes referred to as a “soft liability” because it does not lock the responsible party into a fixed payment schedule. Payments toward unfunded liability fall if investment returns are higher than expected. At high funding ratios, unfunded liability can “pay itself off” without the need for higher employer contributions. At lower funding ratios, the probability that investment returns will be sufficient to pay off unfunded liability becomes more remote. At some point, it is virtually impossible for a system to “self correct” and pension liability becomes equivalent to “hard” debt.

A \$3 billion cash infusion in FY15 boosted Alaska’s funding ratios significantly, but the systems remain billions of dollars away from being able to expect investment results alone to eliminate unfunded liability. In that regard, the distinction between soft and hard liabilities is far less important than the lack of a guarantee that earnings on POB proceeds will exceed debt service costs.

may reduce investment returns. In any event, it is real returns that matter, not the rate that is plugged into a model.

The risk of losing money on POBs (due to lower-than-expected investment returns) decreases as the investment horizon lengthens, but large investment losses soon after issuing POBs can create a hole that may be impossible to climb out of without increasing contributions. The annual loss or gain from issuing POBs is pretty much a roll of the dice. When evaluating POBs, legislators should consider sensitivity analyses that include several scenarios with rates of return other than a steady 8%. The attached sensitivity illustration shows a scenario in which POBs are a losing proposition.

Despite the lack of guarantees, the potential for gains from POBs is attractive. In deciding whether to accept the risk and issue POBs, the following guidelines/advice may be useful.

1. Avoid issuing POBs for the Public Employees Retirement System (PERS). PERS is a shared cost system (meaning all employers have the same contribution rate) with a unique twist: the employer contribution rate is capped at 22% and the state contributes on behalf of employers if the Annual Required Contribution rate is above 22%. The potential benefit of POBs (to the treasury) declines dramatically if a cash infusion drives contribution rates below 22%. At rates below 22% all non-state employers will benefit from lower contributions while the state pays the full cost of debt service.⁴

The projected PERS contribution rate is about 25%, leaving room for no more than \$2 billion in POBs (assuming we want all benefits to accrue to the state). That is plenty of headroom under current circumstances, but the state may prefer to leave room for an increase in the cap on employer contribution rates. Increasing the cap would provide immediate savings to the state with none of the risk associated with POBs. If the rate cap were increased to 25%, there would be little room for POBs in the PERS system.

2. The Teachers Retirement System (TRS) has about \$1 billion of headroom to issue POBs because the state is effectively the only employer and, therefore, the only potential beneficiary of POBs. The \$1 billion limit would bring the TRS funding ratio to about 90%. To put that number in perspective, consider that
 - less than \$1 billion of POBs were sold nation-wide in the first half of this year, and
 - funding ratios above 90% (in both PERS and TRS) should be avoided because they increase the probability that high investment returns would trigger ad hoc pension adjustments that increase payout (and contribution rates) and reduce the benefit of POBs.

⁴ While it may be possible to execute a debt sharing agreement with other PERS employers, doing so would likely be complicated and contentious. Statutes also allow an employer contribution to be credited to that specific employer, thereby reducing future contribution rates only for that employer. That is also a complication for a cost-sharing plan.

As with PERS, there are concerns that issuing POBs for TRS might limit the ability to raise the statutory cap on employer contribution rates without affecting ad hoc pension adjustments. This level of concern grows with the probability that the legislature addresses K-12 costs via increases in the statutory TRS contribution rate rather than by reductions in the base student allocation.

3. There are alternatives to POBs that offer lower risk and greater benefits. Although a pure cash infusion is probably a non-starter given our declining reserves, general obligation bonds have lower costs of issuance and lower interest rates. Although general obligation bond proceeds cannot be deposited into retirement accounts, we could select a number of large capital projects that are currently funded with general funds, change their source of funding to bond proceeds, and deposit the general fund savings to TRS. There is about \$4 billion appropriated, but unspent, for capital projects. The lower interest rate on general obligation bonds (relative to POBs) would greatly
 - reduce risk by widening the spread between the interest rate on debt and the rate of return on invested funds and
 - increase the potential gain associated with using debt to provide a cash infusion to retirement accounts.

General obligation bonds have an interesting twist: they must be approved by voters. This provision offers an opportunity to gauge the risk tolerance of citizens for what some citizens might call “speculative use of public money for the benefit of rich state workers.”

4. The impact of POBs on Alaska’s credit rating and bonding capacity should also be considered. Issuing POBs can be viewed as an act of desperation intended to address fiscal problems. If raters believe that taking on additional debt to address fiscal problems is not in the best interest of the state, POBs could contribute to a rating downgrade and consequent increase in the cost of issuing future debt. Raters might also conclude that a small sale of POBs is a prudent reaction to our fiscal crisis and be neutral (or even positive) about such a sale.
5. Actuarial models show that state assistance in FY17 will be about \$215 million, which is a substantial reduction from the \$260 million required in FY16 and is far below the more than \$700 million that would have been required before the legislature’s action in FY15. While 1) expenditure reductions without service reductions are always welcome and 2) consideration of financial strategies should always be encouraged, retirement assistance is no longer one of Alaska’s three primary cost drivers and the risk inherent in issuing POBs may be less attractive as a result.
6. Timing is critical to the success of POBs. Some may argue that interest rates are likely to go up in the near future and that Alaska is on the verge of a credit rating downgrade. Their conclusion is that “if you’re going to issue POBs, now is the

time.” Others, like the Government Finance Officers Association, have changed their usual cautionary warnings about the risk of POBs and now officially recommends against using them.

The graph below illustrates the following points:

1. If future earnings were a constant 8%, POBs would offer substantial benefit to the treasury.
2. A steady 8% return is not imperative to a positive outcome; if future earnings repeated annual earnings of the last 24 years, the benefits of POBs would be more volatile but would end up being similar to a “constant 8%” scenario.
3. If annual returns on investment of bond proceeds repeated those of a 1993-2015 loop starting in 2001, POBs would have a negative impact for about 15 years before generating a gain to the treasury.
4. If annual returns repeated those of a 10-year loop starting in 2001, POBs would add budgetary stress rather than relieving it. Investment returns would not cover the cost of debt service in many years and the treasury would have been ahead if no POBs were issued.

