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A DOUBLE-EDGED SWORD: THE ECONOMICS OF PENSION OBLIGATION BOND FINANCING FOR LOCAL GOVERNMENTS

OCTOBER 24, 2012
10:00 – 11:45 AM PT

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INTRODUCTION

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A DOUBLE-EDGED SWORD: THE ECONOMICS OF PENSION OBLIGATION BOND FINANCING FOR LOCAL GOVERNMENTS

MODERATOR: THAD CALABRESE PH.D,
ROBERT WAGNER GRADUATE SCHOOL OF MANAGEMENT

SPEAKERS:

ROGER DAVIS
PARTNER
ORRICK HERRINGTON & SUTCLIFFE

JENNA MAGAN
PARTNER
ORRICK HERRINGTON & SUTCLIFFE

ROB LARKINS
MANAGING DIRECTOR
RAYMOND JAMES/MORGAN KEEGAN

BRIAN WHITWORTH
SENIOR VP
FIRST SOUTHWEST

WEBINAR OBJECTIVES

- Background on Governments' Usage of POBs
- Factors Governments Should Consider Before Issuing POBs
- Factors to Consider in Structuring a POB issuance
- How to Assess POB Performance Post-Issuance

PUBLIC PENSION COSTS ARE INCREASING

Several reasons why pension costs continue to rise:

- Some pension systems have lowered their expected earnings assumption, as well as other demographic assumptions (longer retirements, for example)
- Investment returns have been volatile
- At the same time, revenues have been down or flat while needs have increased – causing increased budgetary stress

MANAGING THE STRESS

In this context of budgetary stress, governments have three options with respect to pension costs:

1. Pay the required cost and reduce other services/increase taxes
2. Not pay all or part of the required cost (note: some do not have this option)
3. Fund pension cost and/or accumulated liability with POB

Governments have also:

1. Changed benefits for current retirees (for example, not giving ad hoc COLA's)
2. Increased the costs borne by employees

WHO HAS USED POBs?

- Most POBs have been issued by small local governments – especially school districts
- Most POB \$ through states (IL, CT, WI, OR largest)
- Tend to be financially stressed with outstanding debt in excess of peers
- That is, governments that probably should not be issuing have in many cases

QUESTIONS TO CONSIDER AS A GOVERNMENT

- If markets do not improve over the next few years or decline and no savings are realized, how will we finance both a POB and pension costs? What if we lose significant money?
- What might taxpayers' attitudes about these be? How will they feel if we lose money?
- Why are we considering bonding out a routine operating cost? Symptomatic of deeper fiscal problems? Can we address these instead to avoid taking on risk?

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PANELISTS:

ROGER DAVIS & JENNA MAGAN
PARTNERS AT
ORRICK HERRINGTON & SUTCLIFFE

October 24, 2012

What Are POBs And How Are They Used By Local Agencies In California?

- Pension Obligation Bonds (POBs) are bonds the proceeds of which are paid to a pension fund serving the issuer's employees
- The interest on POBs is not exempt from federal income tax because the proceeds are deemed invested not spent when paid to the pension fund
- POBs are used to
 - ▣ pay a portion of the issuer's unfunded accrued actuarial liability (UAAL), or
 - ▣ pay its current annual contribution, or
 - ▣ both

What Options Are Available For Structuring POBs?

- Obligations imposed by law
 - ▣ Issued as refunding bonds under Local Agency Refunding Law to refund a portion of the issuer's outstanding obligation to the pension fund
 - ▣ Because the outstanding pension obligation is considered an “obligation imposed by law” it is exempt from the California constitutional prohibition on cities or counties incurring a debt or liability without a vote
 - ▣ A validation action is needed to establish that the bonds, as refunding bonds, take on the same characteristics as “obligations imposed by law” as the pension obligation being refunded
 - ▣ A validation is not required for local agencies other than cities or counties, because other types of local agencies are not subject to the constitutional debt limit
 - ▣ Appropriation contingent bonds
 - ▣ Lease – leaseback bonds

Why Issue Taxable POBs?

- Interest rate savings
- Discounts for early payment
- Budget relief
- Arbitrage
- Labor relations
- Financial management

What Are The Risks?

- Lower return on investment by the pension fund of the POB proceeds than interest paid by the issuer on the POBs
 - ❑ impossible to know until final maturity of the bonds
- Concentration rather than spreading market timing risks
- Replacing a somewhat flexible obligation with a fixed one
- Most POBs are non-callable
- If fund too high percentage of UAAL or enjoy greater than expected earnings, pension fund may become overfunded, inducing labor to ask for increased benefits

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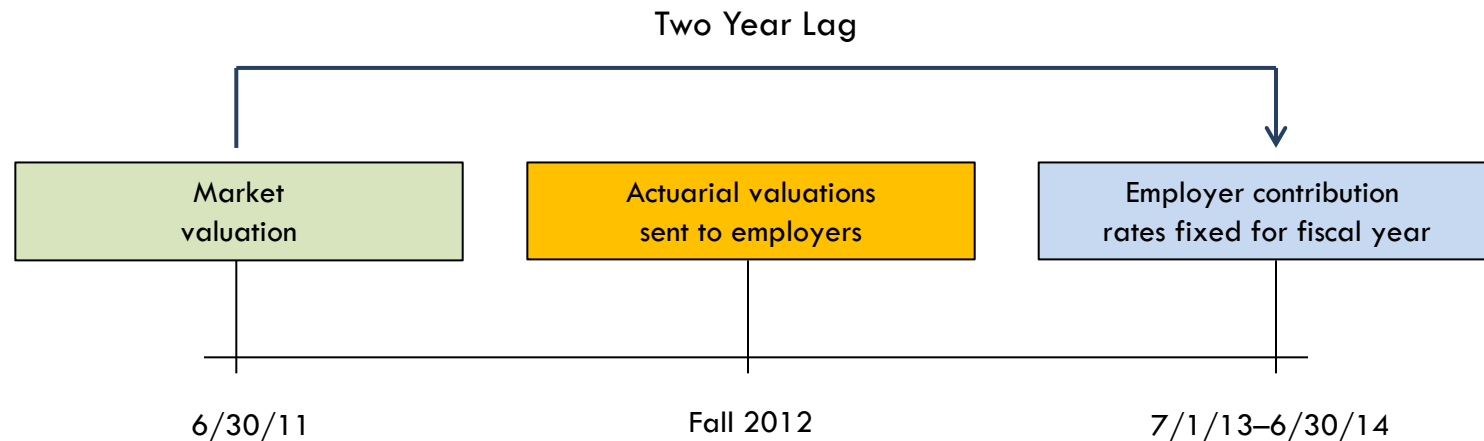
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Economic conditions that make POBs more (or less) advantageous

- There are multiple reasons issuers might consider POBs:
 - ▣ Budget relief
 - ▣ Enhance funded ratio
 - ▣ Transition to Defined Contribution
- Generally, it's advantageous to issue POBs when cost of funds < actuarial earnings assumption
 - ▣ Ultimate benefits will only be known over longer term, depending on actual earnings
 - ▣ “PERS Side Fund” transactions are different because legacy UAAL is amortized as a fixed rate obligation
 - I. Investment Gains/losses borne by rest of Risk Pool
 - II. Earnings below assumed rate will not create a new UAAL for the Side Fund obligor, though the agency could realize a new UAAL for other pension plans in PERS

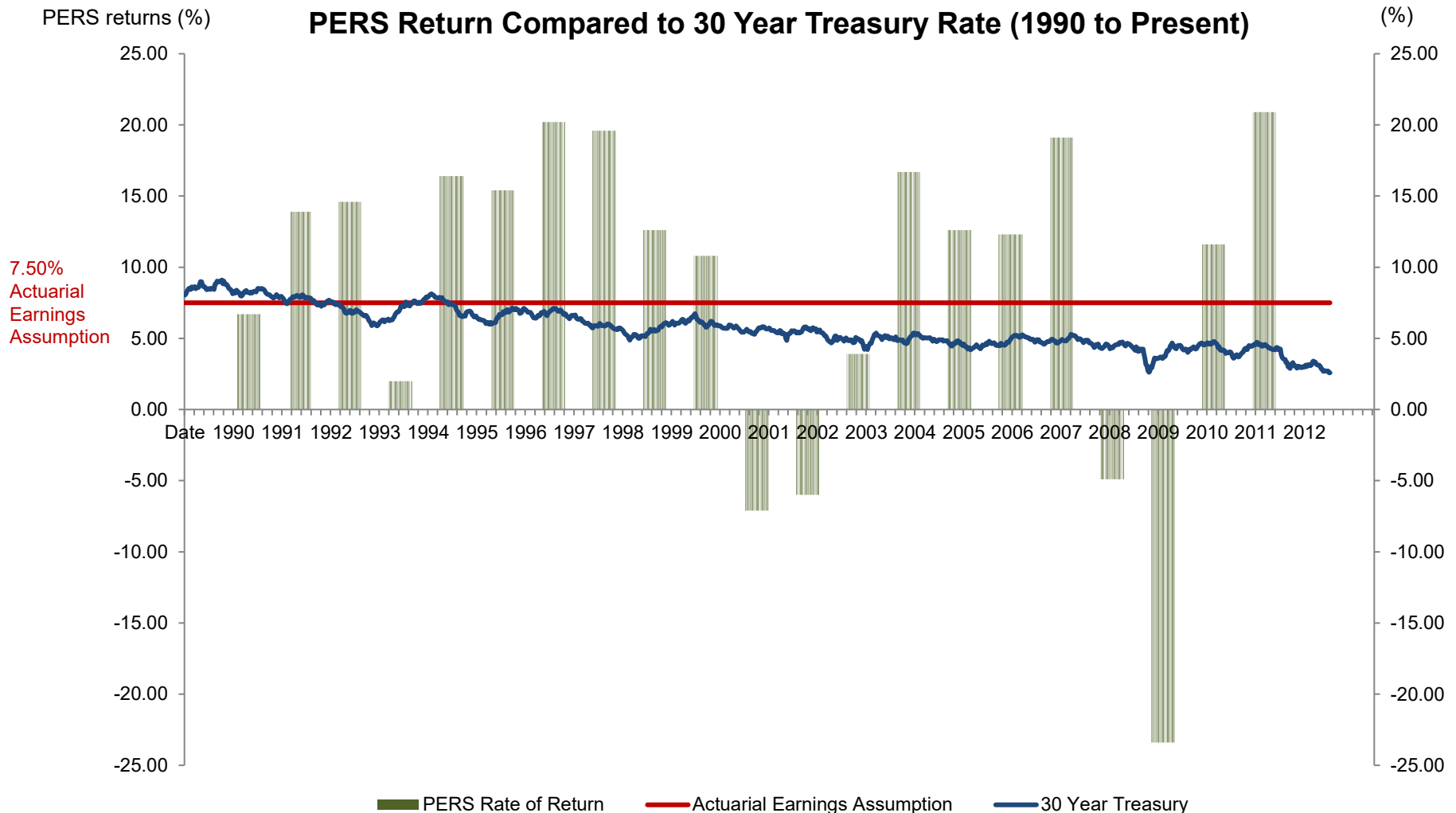
Lagging valuations and smoothing methodologies muddle nexus between market performance and issuer contribution rates



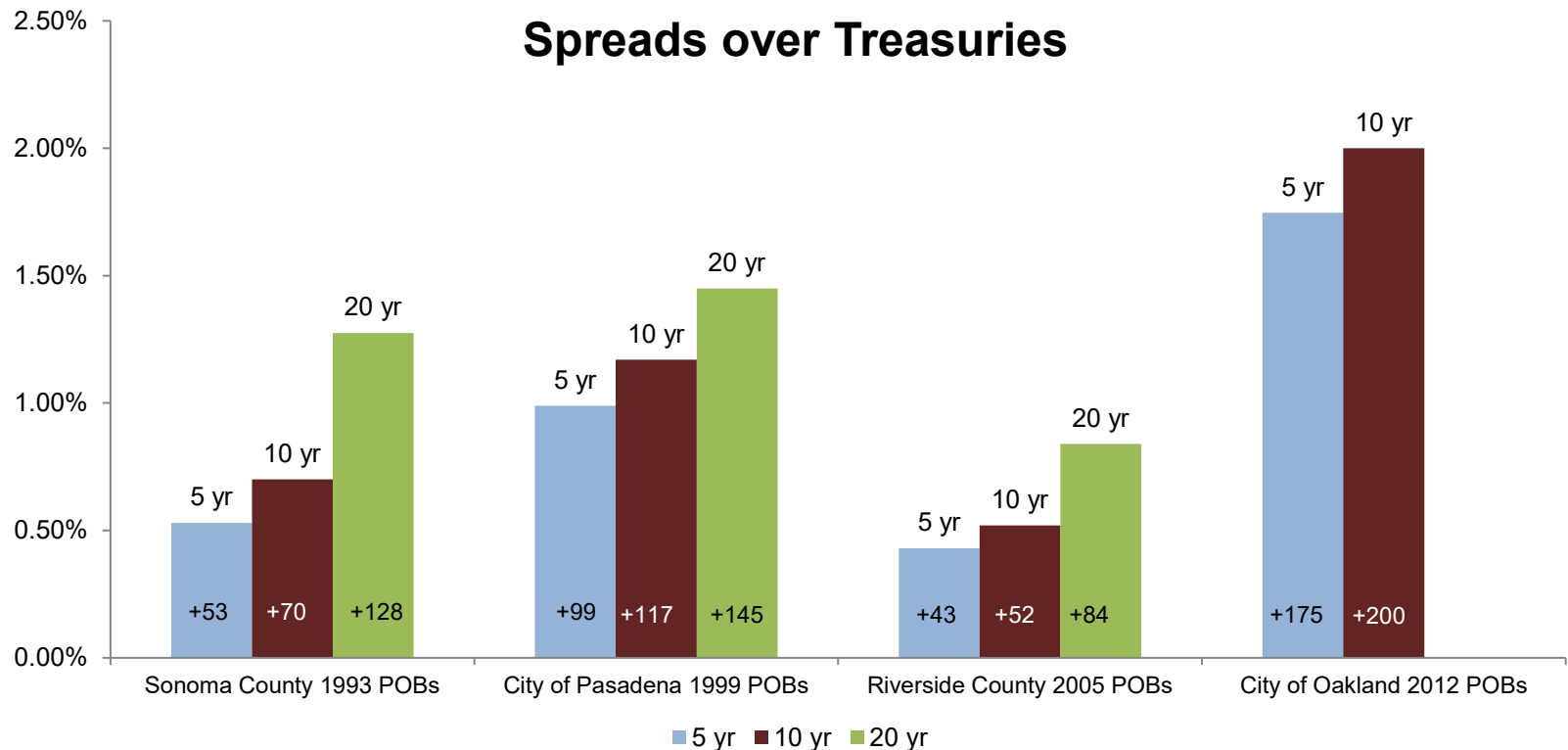
- 2 year lag between actual investment results and budget year when revised Contribution Rates are effective
- 15 year smoothing of “normal” investment performance intended to dampen contribution rate volatility
 - ▣ PERS can also modify its “corridors” to reduce “rate shock”

Ideally, borrow when rates are low and equities are on verge of sustained rally!

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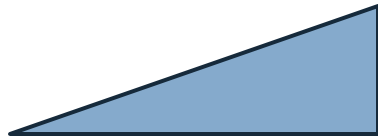


However, Treasury rates are only part of the equation---credit spreads are equally important



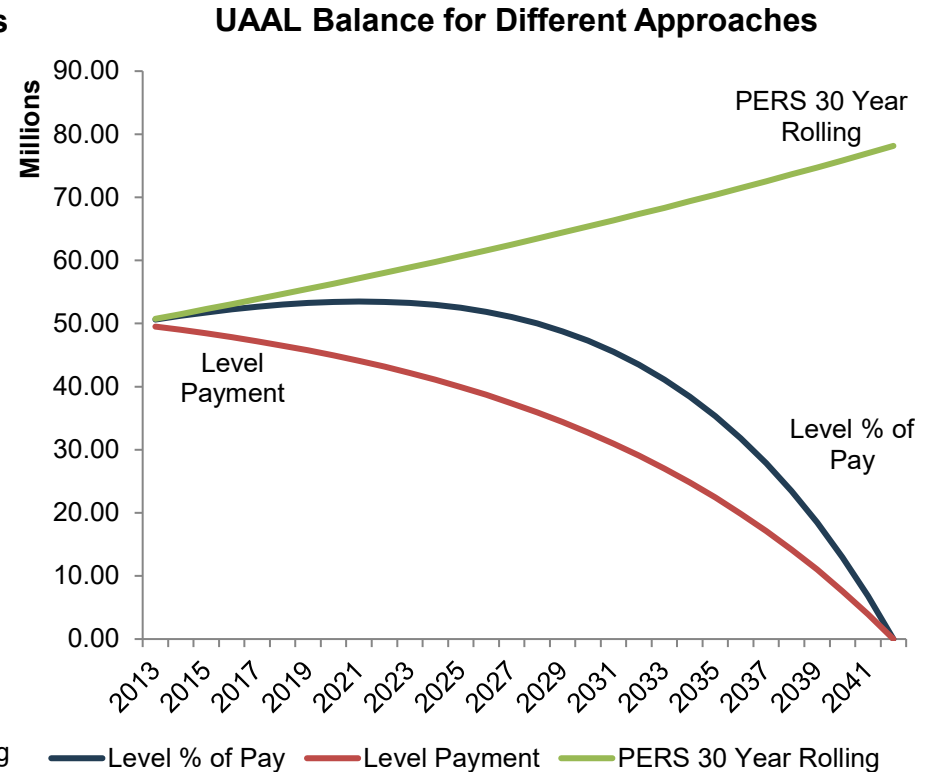
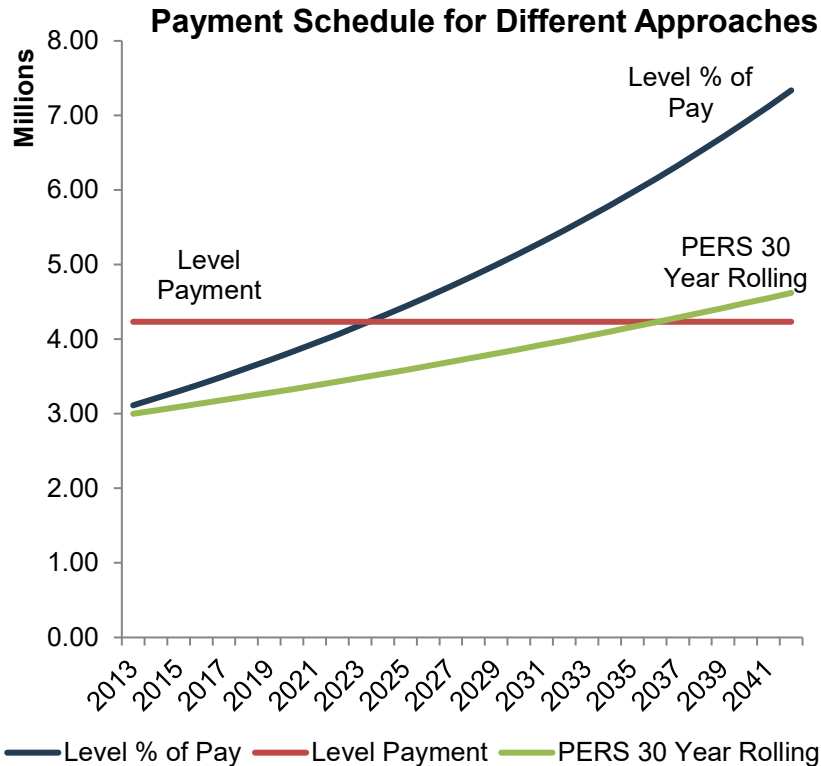
Understanding UAAL amortization methodologies: triangles, rectangles and hockey sticks

- Actuaries back into the Employer Contribution Rate – expressed as a percentage of payroll—sufficient to retire the UAAL over a finite time period IF all actuarial assumptions are met
- Math assumes that payroll grows at a constant rate (currently PERS assumes 3.0%)
- Most common UAAL amortization (outside of PERS) is “level percentage of pay”
- Resulting cash flow is right triangle vs. a rectangle for “level payment” and a hockey stick for PERS’ “30 year rolling”



- Typically, there is negative amortization built into a level percentage of pay schedule because the early year cash flow is insufficient to cover the accruing interest (7.5%)
 - ▣ This is not immoral or evil. It's just the math

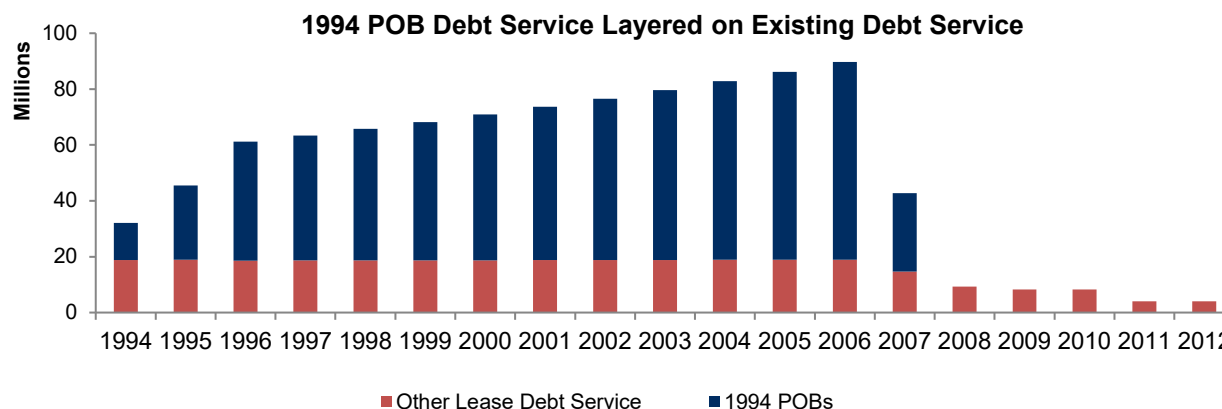
Comparison of Approaches: \$50 Million UAAL



- Under PERS current approach, if all assumptions are spot on, after 30 years, the UAAL will have grown by 56%

Structuring considerations: Solve in a silo or holistically?

- “Original vintage” of POBs were all structured to produce savings versus existing UAAL amortizations
 - ▣ Typical shape was a “shark fin,” reflecting remaining term of existing, finite “level percentage of payroll” UAAL amortizations
 - ▣ For example, San Diego County’s 1994 POBs refinanced the remaining 13 years of a 30 year amortization that began in 1977



- When that “wedge” is layered on top of existing debt profile, it creates its own budget challenges

Fixed vs. Variable?

- Important to bear in mind that existing UAAL is amortized as a percentage of payroll
 - ▣ Cost typically allocated to departments
 - ▣ Subject to a thicket of conditions, pension costs ARE an allowable expense for claiming reimbursements from Federal/State programs
- With fixed rates so low, why would anyone consider variable?
 - ▣ Is the goal lowering the interest cost or preserving callability (or both)?
- Intra-year variable rate exposure presents significant budgeting/accounting issues, and is a reimbursement claiming nightmare
- Annual mode floaters are a better mouse trap than VRDNs or Index Notes
- Despite today's ultra-low interest rates, POB refundings have been limited because vast majority of issues were effectively non-callable (and the claiming rules for refundings are Orwellian)
- History indicates that paying for a "muni" par call was a GREAT bet.
 - ▣ "Make whole" calls are almost never advantageous for the issuer

Reinvestment Issues

- For most issuers, reinvestment is out of your hands—the legal/fiduciary responsibility for asset allocation and investment decisions rests with the Plan and not the Employer
 - ▣ Still, reinvestment is THE primary risk
- Closed plans present unique challenges
 - ▣ Important to evaluate asset base vs projected benefit payments (“burn rate”)
 - ▣ Does it make sense to reinvest in equities that will need to be sold in 3-5 years to pay benefits?
 - ▣ For plans in “runoff mode,” a heavy weighting towards fixed income makes sense.
 - I. Can you earn 7% when 2s, 5s and 10s are yielding .25, .65 and 1.69%?
 - II. “You can’t pay benefits with assumed earnings.”

Conclusion

- Evaluating the risks and benefits of POBs is considerably more involved than simply comparing the existing actuarially assumed earnings rate and your cost of borrowing
 - ▣ POBs are very situation-specific
- There are a host of complex underlying actuarial dynamics to be considered
 - ▣ Finance team should include an independent actuary
- Issuers need to go into POBs with their eyes wide open and understand that “savings” is a long-term proposition

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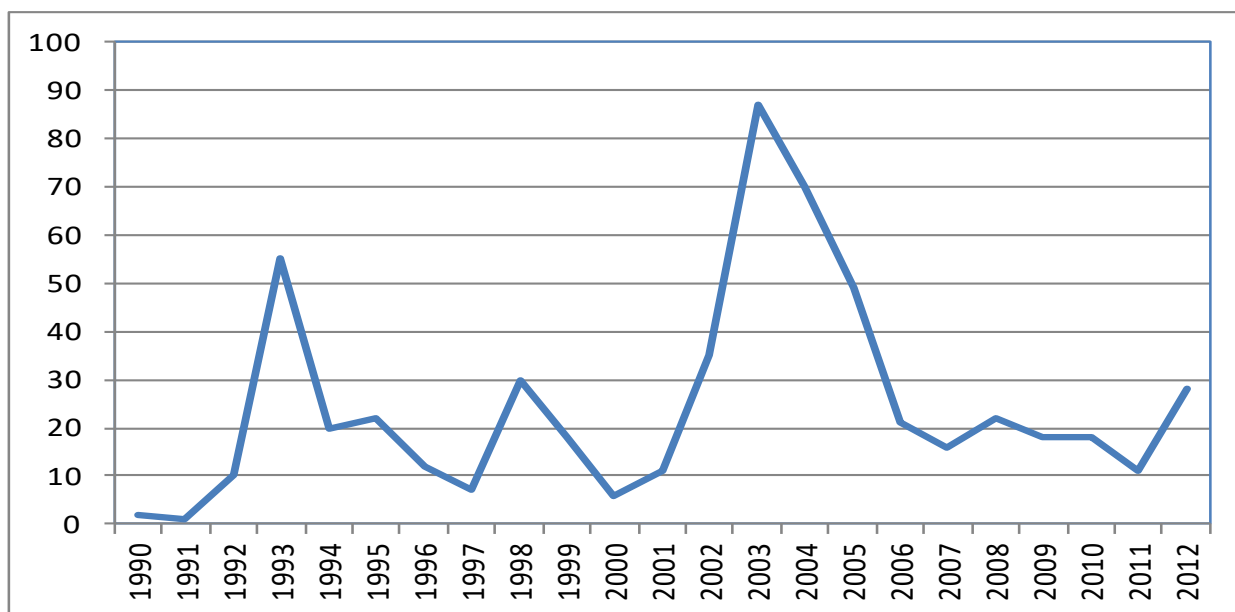
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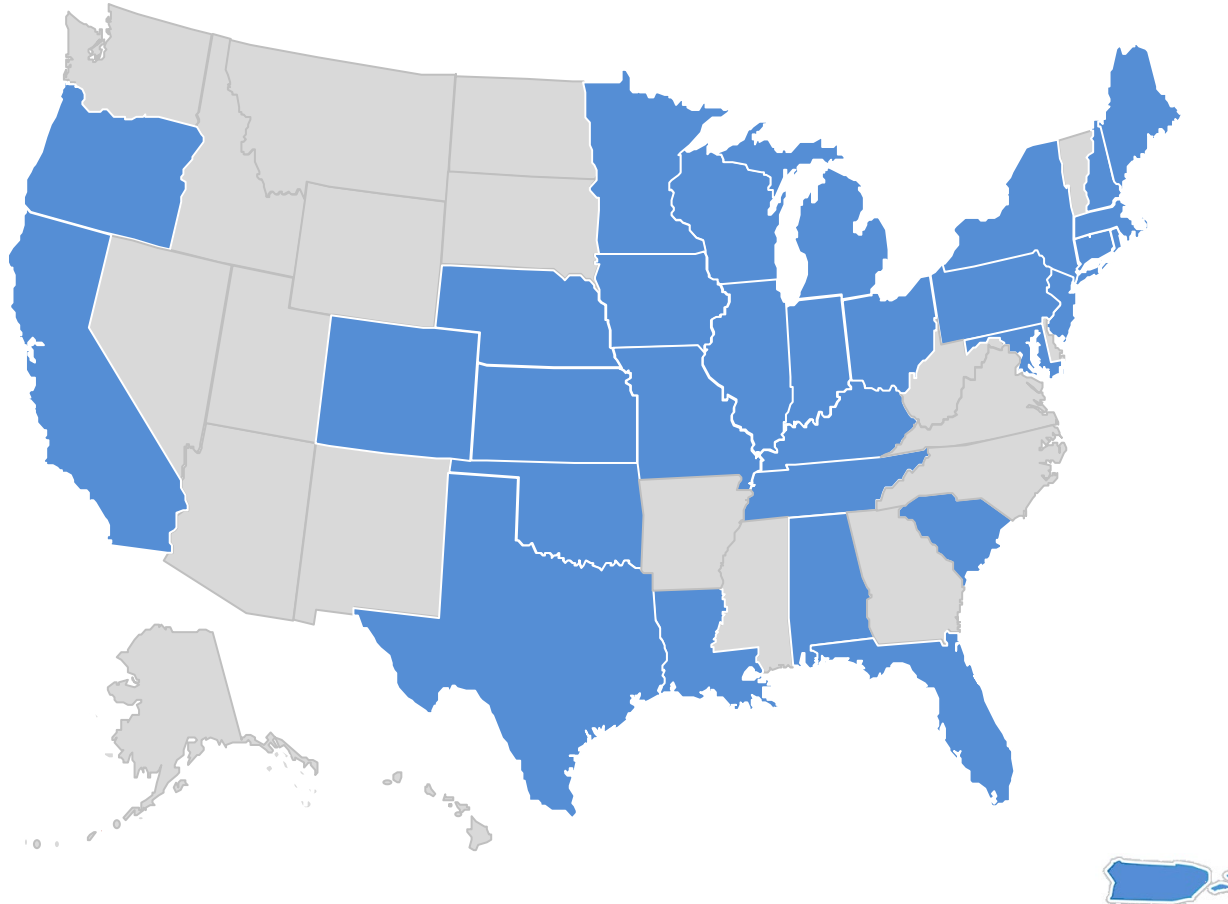
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Summary Statistics on Pension Bonds

- Since 1990, approximately
 - \$71 billion in bonds issued
 - \$18 billion in CA
 - 560 bond issues
 - Bonds issued in 31 states
- Number of bonds issued by year (2012 numbers annualized):



States Where Pension Bonds Have Been Issued

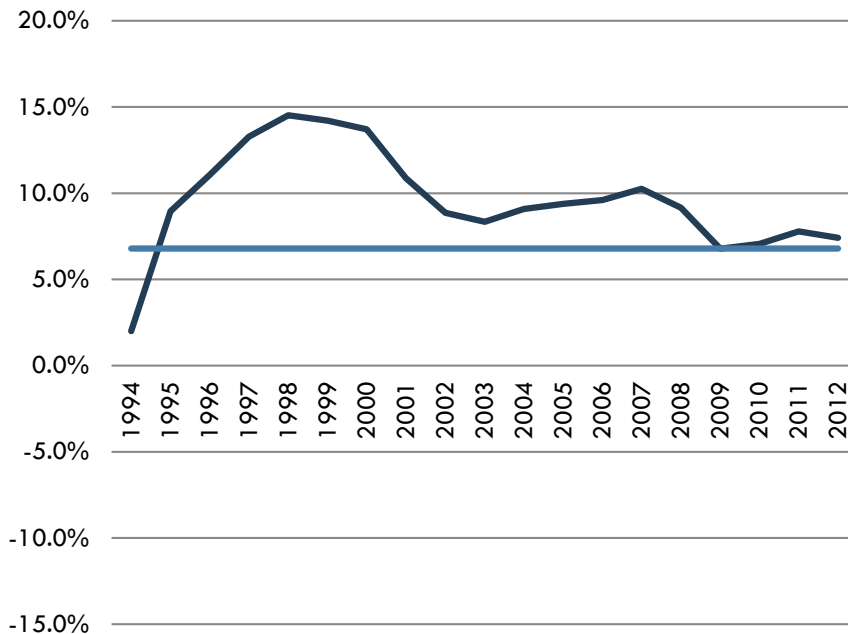


Will The Pension Fund Have Higher Returns Than Pension Bond Borrowing Costs?

- Assuming fixed rate borrowing, you know your max borrowing cost at issuance
 - ▣ Pension bonds may have unlimited refundings, but often include market or make whole calls
 - ▣ Some attempts at tenders and open market purchases have been made for outstanding bonds
- Good chance pension investment returns will be lower than borrowing costs at some points, and higher than borrowing costs at other points
 - ▣ If issuing, prepare your governing board
- Two examples, from 1994 and 2005

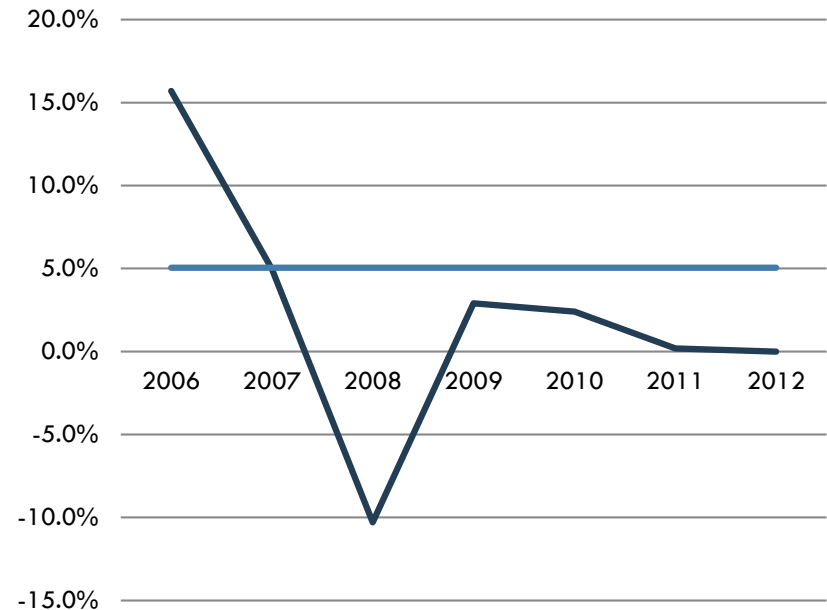
Two Examples of Pension Bond Borrowing Costs vs Cumulative Investment Returns Since Bond Insurance

Early 1994 Pension Bond



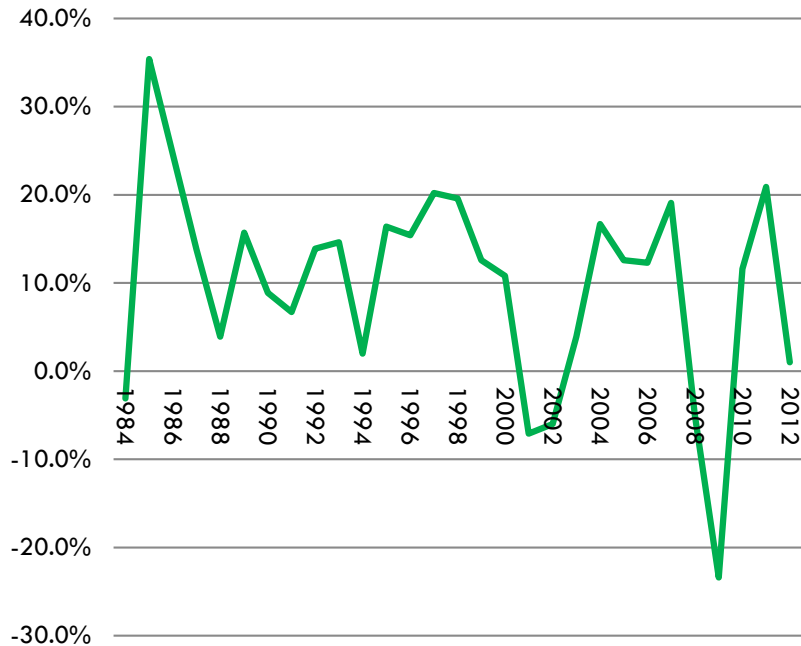
— CalPERS Inv Return Since Bond Issue
— Bond TIC 6.79%

Mid 2005 Pension Bond

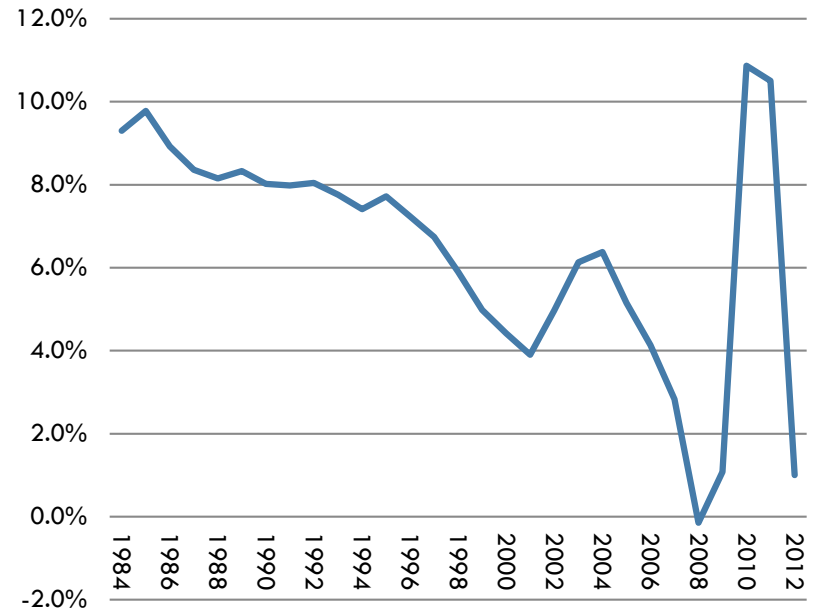


— CalPERS Inv Return Since Bond Issue
— Bond TIC 5.05%

CalPERS FYE 6/30 Returns (Avg 9.3%)



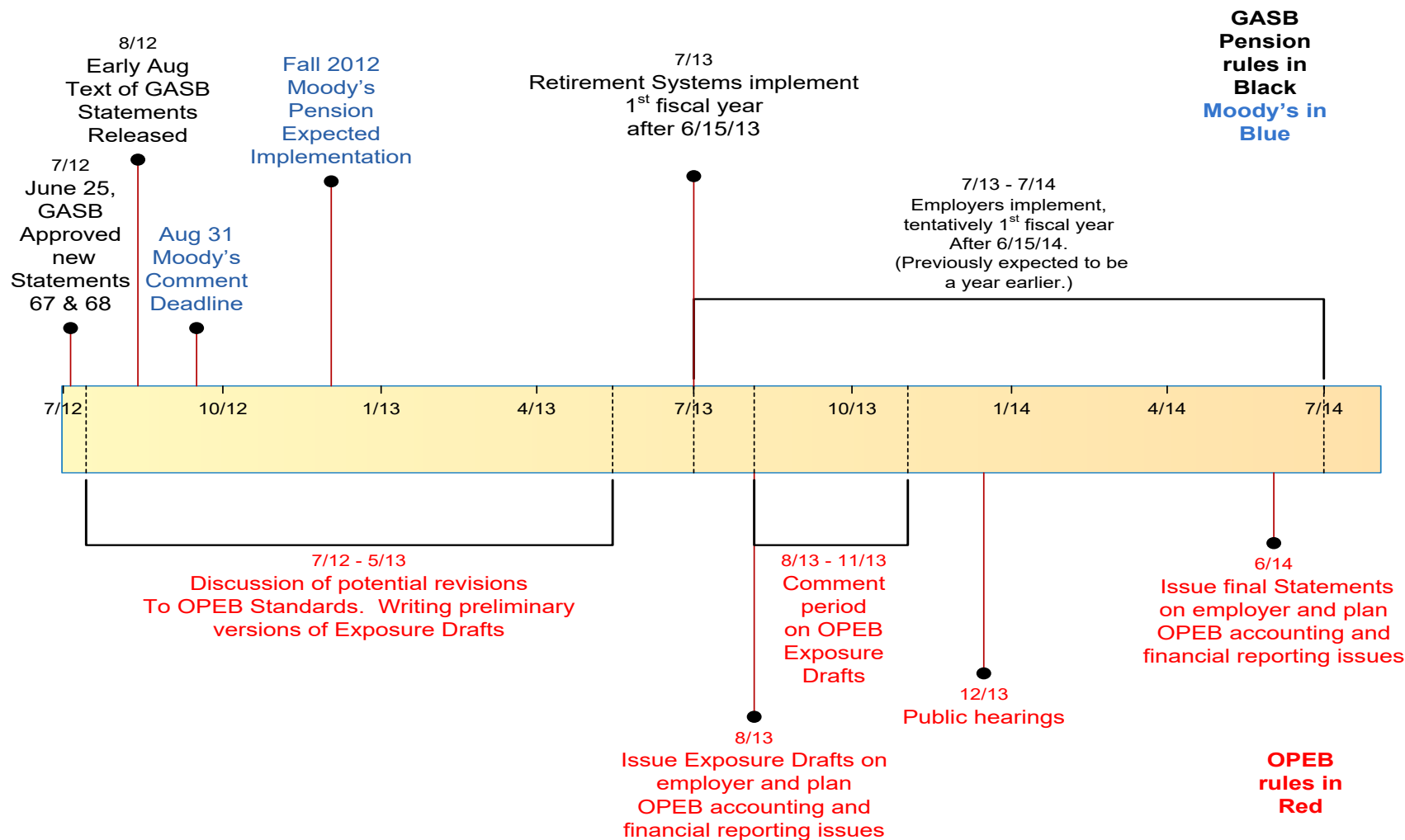
CalPERS Compound Annual Returns Through 6/30/12



Causes of Changes in Unfunded Liabilities & Contributions

Factor	Pension	OPEB
Investment Returns	X	X
Life expectancy	X	X
Age at Retirement	X	X
Employee Turnover	X	X
COLAs	Often	
Wages/Salaries	X	No direct effect, but often used in amortization of UAAL, ARC calculations
Medical Inflation		X
Participation Rate		X
Individual Health Conditions		X
Federal/State Healthcare Law Changes	Occasionally	Often
New Accounting Rules	Occasionally	Occasionally

New Pension & OPEB Timeline – Updated August 2012



What Will the New GASB Rules Change?

- Accounting entries on CAFRs will be different than actuarial funding calculations, called the “divorce” of accounting from funding
- Longer disclosures, many new terms, new or different calculations
- Unfunded liabilities will be on the balance sheet
 - ▣ Renamed “Net pension liability”, and calculated somewhat differently
- For plans near full funding with shorter amortization, likely will use same discount rate as now
- For plans not near full funding, with a long amortization period, and/or historically not contributing the ARC, may use a “blended” discount rate which is lower, perhaps more incentive for pension bonds with this group
- For accounting purposes, Annual Required Contribution (ARC) is replaced by Pension Expense, which is calculated differently than the ARC
 - ▣ ARC will be allowed as a disclosure item under the name ADC (Actuarially Determined Contribution)
- Increased staff time understanding, disclosing, and explaining the changes

Will the New Standards Affect Funding?

The changes “relate solely to accounting and financial reporting and do not apply to how governments approach the funding of their pension plans. At present, there generally is a close connection between the ways many governments fund pensions and how they account for and report information about them in audited financial reports. The proposals would separate how the accounting and financial reporting is determined from how pensions are funded. Should the proposals become accounting and financial reporting standards in the future, governments would not be required to mirror the accounting and financial reporting changes in their funding approaches.” (Source: GASB’s Exposure Draft Supplement: Plain Language Supplement, June 27, 2011).

- However, we are already seeing employers and retirement systems consider changes:
 - ▣ Changing an actuarial method, such as from projected unit credit to entry age normal
 - ▣ Changing from an open to a closed amortization
 - ▣ Shortening amortization
 - ▣ Deciding to make the full ARC payment, at least from the implementation date forward
 - ▣ Benefit and eligibility reforms. Many of these have much more effect on the blended rate calculation than on ARC or unfunded liabilities under current rules.

Disclosures About New Pension Accounting Rules

- Especially for pension bonds, investors may be interested in knowing about the new accounting standards, GASB 67 and 68
- If you do not yet have calculations or disclosures under the new rules (typical in Oct 2012, since the rules were only released in August), you may want to provide notice to investors, e.g., *“In June 2012, The Government Accounting Standards Board (GASB) approved two new standards which, according to GASB, ‘will substantially improve the accounting and financial reporting of public employee pensions by state and local governments. Statement No. 67, Financial Reporting for Pension Plans, revises existing guidance for the financial reports of most pension plans. Statement No. 68, Accounting and Financial Reporting for Pensions, revises and establishes new financial reporting requirements for most governments that provide their employees with pension benefits.’*
- *“For _____[issuer], the required implementation date is fiscal year ending _____. As of _____[date], _____[issuer] has not obtained calculations under the new standards. The new standards will result in changes to pension disclosures, and will introduce new terms and calculations.”*
- May want to include comments about the relevance of GASB 67 and 68 to any validation proceedings, and any relevant material from bond counsel and/or disclosure counsel
- For some future pension bond issues, whether the validation proceeding occurred after the release of the new rules, and whether material regarding the new rules was included in the validation

Will Pension Bonds Change Under the New Rules?

- It does not appear that the upcoming GASB changes will have any direct effect on existing pension bonds
- For pension validations after implementation of new GASB rules, good chance both funding and new GASB accounting calculations will be included in validation documents
- Accounting will be different for pensions, whether or not you issue pension bonds

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