Pension Bonds Draining Municipal Agencies.

Desperate to cover a $40 million shortfall in its pension fund for retired police officers and firefighters, the city of Richmond turned to an exotic loan.

But instead of tightening spending after it issued the $36 million pension obligation bond in 1999, city leaders increased the retirees' pensions.

Today, Richmond still owes more than $12 million on the bond, plus about $5 million in interest, and its pension fund remains roughly $12.5 million short. To narrow that gap and cover the debt, the city is dipping into proceeds from a supplemental property tax on residents and businesses.

The city's fiscal approach has residents like Joe Bako scratching their heads. "When you're short on funds, you don't start spending more," he said.

Some public officials and investment bankers have portrayed pension obligation bonds as a good way to shore up pension funds. The proceeds can be invested in the stock market, reaping returns potentially higher than the bonds' interest rate.

Bonds in the red

But that gamble is not panning out so far for at least five pension obligation bonds issued by California public agencies between 1999 and January, an analysis by the Center for Investigative Reporting has found.

In addition to the city of Richmond's Police and Firemen's Pension Fund, agencies with bonds in the red include Merced County and the Pasadena Fire and Police Retirement System.

Average returns on investments also have not kept pace with net interest costs on recent bonds in two other California counties: San Diego and San Bernardino. Because those bonds were issued within the past six years, it is too soon to determine how they will perform.

Since 1999, local governments and special taxing districts in California have sold more than $11 billion in bonds to shore up their pension obligations, according to the state treasurer's office.

Emboldened by the infusion of cash from pension bonds, some municipalities have enhanced employee pensions or buttressed needs elsewhere by suspending pension contributions.

"It is basically a principle where they're printing money," said Chester Spatt, a former chief economist for the Securities and Exchange Commission and a finance professor at Carnegie Mellon University. "These (bonds) strike me as irresponsible, especially in light of what we've learned" from the 2008 financial crisis.

Sign of larger problems

The bonds do not require voter approval and, by the time they are paid off, many of the public officials who approved them are long gone. “The decision happened before I got here,” said Bill Lindsay, who became Richmond’s city manager in 2005. “Applying hindsight to investment returns, I wish I could do that for my entire life.”

Yet even after the downturn, and with growing knowledge of the risk involved, many governments continued to rely on pension bonds.

In the five places in California where pension bonds are underperforming so far, the shortfall also warns of deeper financial problems, said Thad Calabrese, assistant professor of public and nonprofit financial management at New York University. Residents of such areas might face service cuts and higher taxes, he said – or worse.

“Instead of negotiating with the unions and imposing pension reforms, for example, this is a way of kicking the can,” Calabrese said.

Pension obligation bonds figured prominently in last year’s bankruptcy in Stockton, which issued $125 million in pension bonds in 2007 – after it had improved retirement benefits and compensation several times. Stockton’s invested pension bond proceeds lost about a third of their value in the stock market crash.

Detroit, the largest U.S. city to file for bankruptcy because of a shrinking tax base, declining population and other factors, failed to realize expected returns after issuing pension bonds in 2005 and 2006.

Agencies downgraded

Credit rating agencies increasingly are downgrading the creditworthiness of public agencies with pension bonds, which can make future borrowing more expensive. This year, Moody’s downgraded pension bonds in Santa Clara, Marin, Contra Costa and Sacramento counties.

In 2010, lawmakers in Pennsylvania prohibited the state from using pension obligation bonds, citing the financial risks. And the federal Government Accountability Office has warned that pension bonds can leave some governments “worse off than they were before.”

The nation’s first pension obligation bond was issued in 1985 for $222 million by the city of Oakland with the help of Wall Street. Roger Davis, a lawyer who consulted on the deal, said it was pulled together by the then-city manager and Goldman Sachs, with assistance from his firm, Orrick, Herrington & Sutcliffe. It may well have been conceived, he said, to enrich the pension fund without adding to the debt load.

At the time, that was a safer bet. Public agencies could issue bonds at a tax-exempt interest rate and invest in annuities, in most cases guaranteeing a rate of return higher than the owed bond interest. The next year, federal legislation removed the tax-exempt option.

A growing number of jurisdictions continued to turn to the bonds to cover raises and benefit increases given out in flush years. Then economic downturns sapped the investments.

That was the case in Oakland, which issued another pension bond for $436 million in 1997 and suffered heavy losses when the stock market plunged 11 years later. Debt deepened when the city took a 15-year break from making police and fire pension contributions. The payments resumed in 2011, but last year the city issued another pension bond for $212 million.

“They’re on their third credit card,” said Alameda City Manager John Russo, who voted against the

1997 bond when he was a member of the Oakland City Council.

Oakland’s obligations

Oakland’s current plan is to help balance the budget by taking another pension contribution holiday through June 2017. Budget problems also have forced the city to shed a quarter of its police force since 2008.

A supplementary tax on property owners in the city will generate an estimated $68 million this fiscal year, said Scott Johnson, who until last month was Oakland’s assistant city administrator. That will help repay some of the bond and the system’s unfunded pension obligations, he said.

“I feel we’re in a strong position,” Johnson said.

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