[Bond Case Briefs]

Municipal Finance Law Since 1971

[Finance 101 Glossary.]

Crucial (and complicated) concepts in public money explained.

This is part of an ongoing series called Finance 101 that goes back to the basics to help public officials.

13th check

A perk of some pension programs, the 13th check refers to an extra check retirees (and in some cases, current employees) receive at the end of a fiscal year if a pension fund has performed better than expected. The practice is controversial because pension fund rates of return vary from year-t--year and actuaries rely on an average rate of return over multiple years to do their accounting of the fund's liability. For example, in 2013, San Diego's pension fund realized investment earnings for the fiscal year (ending June 30) of $241.7 million. Costs for the fund, including retiree payments and broker fees, were $150.7 million. That left a balance of $91 million that was large enough to trigger that city's 13th check program and retirees received a check at the end of 2013.

Basis Point

1/100 of a percent. Basis points are used as a unit of measurement in contexts where percentage differences of less than 1 percent are discussed. This is commonly used when referring to interest rates or investment yields.

Cash Balance Pension Plans

A cash balance plan is a common type of hybrid pension plan. Like a Defined Benefit plan, contributions from employees and employers are pooled and professionally managed. But the benefits employees actually get is based on the amount accumulated in the account (not on a formula based on salary and years of service). Employers guarantee a minimum rate of return, though the payout is likely to yield lower yearly returns than a traditional pension plan. This model helps reduce and manage future liability for the employer.

Defined Benefit Pension Plan

Often referred to as a "DB" plan, these retirement plans have up until recently been the mainstay for pension plans in both the public and private sector. Here, employees contribute money from their paychecks every pay period. But what is specified (or "defined") as the employee's benefit is what the employer will pay out each year following the employee's retirement. Therefore, the risk is being taken on by the governments. Projecting what governments will actually have to pay out is difficult, especially when retirees live for a long time.

For example, a government hires an employee who will earn a pension that will amount to 75 percent of his $80,000-a-year salary once fully vested. After 25 years, the pension vests and he retires to a $60,000-a-year pension. The pension will encourage the employee to stay with the government for most of his career, giving the government stability in personnel. But the government is taking on the investment risk – there is no guarantee that the money invested in the employee's pension over the course of his career will cover the annual $60,000 payout. But the government is still on the hook.

Defined Contribution Pension Plan

Often referred to as a "DC" plan, these retirement planscan include 401(k)s (most common in the private sector), 403(b)s (used by educational institutions) and cash balance plans. In these plans, what is actually specified (or defined) as the employee's benefit is the employer's contribution to the retirement plan each pay period. (Of course, employees contribute too.) The benefit to governments is that the risk is taken on by the employee and makes planning for retirement benefits much easier. For example, Employee X will contribute 10 percent from his paycheck (pre-tax) to his pension fund and the government will match that. If the employee earns $80,000 per year that means that $16,000 is being stocked away in his retirement account annually. If that person works for 25 year, that means that a total of $400,000 will be invested into the retirement fund over that time

But that's where the guarantee ends – depending on how the market does over those 25 years that employee's pension could be worth more than double what was invested or it could be less than $400,000. That's why the risk is taken on by the employee in 401(k)-style plans as there are no guarantees on what the employee will have upon retirement.

General Obligation Bond

The gold standard of bonds, these are issued directly by state or local governments or their agencies to meet essential government functions (e.g. infrastructure funding). These bonds are backed by the full faith and taxing power of the issuing government and, as such, are considered the bonds least likely to be subject to a default. A government's credit rating usually refers to its GO bond rating.

Hybrid Pension Plans

These plans are growing in popularity as a middle ground between keeping Defined Benefit plans and doing away with them altogether by switching to a Defined Contribution plan. Hybrids can take varying forms but, in short, they are a defined contribution plan backed up by a lower-level defined benefit plan. For example, one type of hybrid plan caps the employer's contribution to a defined-benefit plan. If the plan's costs are higher than the cap, employees make up the difference. The goal is to have the employee and employer share the investment risk. This helps the employer keep retiree benefit costs in check and gives the employee more retirement security than a DC plan.

Hybrids have been around for years (Indiana has had one since the 1950s) although they have been growing in popularity as more states and localities revise their pension programs. Currently, 15 states and a handful of cities have adopted a hybrid pension plan for their employees – in most cases just for their new hires.

Moral Obligation Bond

A type of tax free revenue bond where government is not legally obligated to appropriate funds to pay a bond debt, but has great incentive to do so in order to avoid a default. For example, a housing authority issues debt for a project but because property values fall, the projected revenue stream is not enough to make its payments to bond holders. In order to keep its good standing on Wall Street and low borrowing costs, the government overseeing that housing authority is obligated to cover the debt payments through other funding mechanisms.

OPEB (Other Post-Employment Benefits)

Generally speaking, OPEB refers to retiree healthcare but can also include other benefits for retirees like life insurance or legal coverage. Unlike pensions, which is also a "post-employment benefit," retiree healthcare is generally not protected or guaranteed. There is also no requirement to pre-fund the benefits whereas pension benefits are paid out of an investment fund maintained by the government. These characteristics have two main consequences: 1) OPEB costs are (except in a very few jurisdictions) are "pay as you go" and governments budget only enough money each year to pay the immediate bill for the retirees. 2) Mounting OPEB liabilities generally don't get the same attention pension liabilities do even after accounting rules were changed in 2007 to require that governments estimate their OPEB liabilities on their balance sheets.

As Joshua Franzel, vice president of research for the Center for State and Local Government Excellence, puts it: "For the most part it's easier to change the benefits or eliminate benefits [as] governments can tweak around the edges or cut out a lot of the subsidies they provide. [So] when these costs continue up, states are shifting more costs over to the retiree."

Revenue Bonds

Bonds issued by a government that are paid through a secured stream (i.e. derived from the financed project, outside grants, or other taxes related to the project). Generally, voter approval is not required for these types of bonds.

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