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The Not-So-Sunny Side of Pension Obligation Bonds.

Some governments, particularly those with money problems, borrow to quickly pay down their pension obligations. But a new study shows it can leave them more financially vulnerable.

A tool that some governments have used to immediately pay down their pension obligations through borrowing can leave those governments more financially vulnerable than they were before, a new study says.

The tool, called Pension Obligation Bonds (commonly referred to as POBs), allows governments to issue taxable bonds for the purposes of putting money toward or fully paying off the unfunded portion of a pension liability. The proceeds from the bond issue go in the pension fund. The theory is that the rate of return on the investment will be greater than the interest rate the government pays to bond investors so that the transaction is favorable to the government; it makes money off the deal.

In actuality, however, a study issued in July by Boston College's Center for Retirement Research found that the stock market and interest rate swings have meant that many governments have paid dearly for issuing POBs, especially those that issued bonds in the mid-2000s or early 1990s. And, because financially distressed governments are more likely to issue the bonds, the results often mean even more financial problems.

The report noted that the governments more likely to issue POBs are ones that have pension plans that represent "substantial obligations." The governments have large outstanding debt and are short of cash. However, rather than necessarily relieving such governments of financial pressures, the bonds actually create a more rigid financial environment. Issuing bond debt to pay off a long-term obligation like a pension liability turns a somewhat flexible pension obligation into a hard and fast annual debt payment. Thus, "governments that have issued a POB have reduced their financial flexibility," the study says.

The governments of Illinois, California and New Jersey have been very active in issuing POBs over the last three decades, according to the report, which converted totals to 2013 dollars. Illinois and California have each issued more than $25 billion total, although more than $10 billion of Illinois' bonds have been issued after the stock market began rebounding in 2009. New Jersey has issued more than $11 billion in POBs since 1985. Yet the states still stand out as having some of the nation's highest unfunded liabilities. Illinois in particular has one of the country's worst funded ratios (less than 40 percent of its public employee pension system is funded). New Jersey and Illinois (and up until recently, California) have also continued to struggle with balancing their budgets, even after the recession ended in 2009.

POBs' net returns (what the investment has earns after making bond payments) has varied, depending on when the bonds were issued. According to the center's research, the net rate of return has averaged in the low, single digits for most years (the 30-year average is 1.5 percent). Governments that issued Pension Obligation Bonds in 1998, 1999, 2000 and 2007 actually lost money on their investment. Detroit, for example, issued debt at the peak of the market in the mid-

2000s to fund its pension plan and did so using a complicated interest rate swap deal. The result was that the deal went the wrong way for the city. Detroit was still on the hook to pay bondholders and though its pension was well funded, it had even less day-to-day cash to meet its financial obligations. That debt played a key role in Detroit's decision to file for bankruptcy last July.

The authors said that POBs do have the potential to be used responsibly — that is, "by fiscally sound governments who understand the risks involved or could play a role as part of a broader system reform package." For example, in 2002 and 2003, Sheboygan County and Winnebago County in Wisconsin borrowed more than $7 million combined and earned investment returns greater than 20 percent on the borrowed money. Meanwhile, they paid less than three percent interest on their debts so earned an extra 17 percent return as a reward for taking on additional risk. But, such examples such are few and far between.

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