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A Green Bond for Public Pensions.

Pension plans want to support environmental projects, but there is one thing holding them back.

Green investments are the current darling of Wall Street. The market for them is expected to exceed $40 billion this year, according to Bloomberg. But there's one huge institutional player who's being left out: state and local pension plans.

"There has been a lot of buzz about infrastructure finance in the public pension community," said Girard Miller, chief investment officer of the Orange County Employees Retirement System (OCERS) and a former Governing columnist. He noted that many pension plans are interested in investments that can boost funding for new infrastructure, especially when those projects are environmentally friendly. The problem, Miller said, is that pension investment officials "don't want tax-exempt paper in their portfolios."

Why? Since pension plans are already tax exempt, they can't claim the tax exemption. That leaves, he says, "a mismatch between available pension capital and the public sector's infrastructure financing needs, especially for projects that lack a revenue source."

Is there a fix? Miller talked about one in a recent interview, which has been edited for clarity and length.

Let's start at the beginning. There are so many definitions of green bonds out there. How are you defining it?

These are bonds issued to finance environmentally friendly capital projects. One use of the concept applies very narrowly to tax-exempt bonds for what are called brownfields development. Then there is also an international working group promoting "climate bonds," which are sometimes called green bonds. CalSTRS, the large state teachers pension fund here in California, is part of that working group. The central idea is to reduce the carbon footprint globally through infrastructure projects that can be funded through big bond issues. I use the term green bonds very broadly to include essential environmental projects that might be funded by states and localities through bond financing. Beyond carbon reduction and water conservation in drought areas, I'll leave it to the policy geeks and public finance guys to haggle over the definition. It's a big tent.

When Connecticut issued a green bond this past October, State Treasurer Denise Nappier said they were developing the bonds "to meet the needs of the growing group of investors who have mandates to invest in sustainable projects that will help preserve our environment for future generations." Where do pension plans fall within this "mandate"?

In OCERS there isn't a mandate, no social objective. The traditional goal is to seek out the best returns. There are other, bigger funds that take a broader view of their responsibility. The word that strikes me as interesting was coined by John Rogers, the past president of the Chartered Financial Analyst Institute: super fiduciaries. These are big funds — like CalPERS or CalSTRS — that take large positions so that they own a chunk of the economy. For them, terms like sustainability mean something because if society at large fails -— especially in terms of environmental concerns — then their overall investments are not going to do well. They feel they have a higher calling than squeezing out the best profit. That's where some of the pension plan interest in green bonds comes.

The problem is that pension plans don't want tax-exempt income. We're not the only ones. Sovereign investment funds from abroad, such as those in China and the Middle East, and endowment funds don't care about taxes either.

What would attract them?

What we need is a taxable option to be approved by Congress and limited to green bonds, not to every conceivable capital project, which is typically what happens when politics gets involved. A taxable bond option (TBO) is a concept that has been kicking around in public finance circles for four decades. As far back as the 1970s, economists like John Petersen were saying there is a smarter way to do this stuff. Build America Bonds, which were authorized in 2009-2010 at the bottom of the Great Recession, were a taxable option. A TBO allows, but does not require, a muni bond issuer to elect to pay taxable interest and receive a direct interest-cost reimbursement from the U.S. Treasury rather than the indirect subsidy of tax exemption. In most cases, that would mean a lower borrowing cost — net-net — than issuing tax-exempt bonds. For pension plans, a TBO-yield will compare favorably with corporate credit and foreign sovereign bonds, plus the bonds would be a diversifier for our bond portfolios. Foreign investors and endowment funds, as well as ordinary investors with incomes below $200,000, would prefer taxable municipals.

What's the objection to them?

Some leaders in the public finance community believe that it's a slippery slope, that if the federal government starts down this path they will someday want to eliminate tax exemption for municipal bonds. Secondly, there has been a fear in some circles that someday the feds will run out of money and renege on their promise to pay the interest reimbursement. In theory, it's harder to renege on tax exemption.

What's the track record with Build America Bonds? Did the federal government keep its commitment? Did the bonds sell well?

Build America Bonds were successful. No one disputes that. It was limited in term, and the bonds got scarfed up and are sitting in people's portfolios. Uncle Sam is paying its share and there's no sign of doing anything otherwise.

What's the U.S. government's interest in a taxable muni?

It costs the Treasury less to pay a direct subsidy to the muni bond issuer than to give a tax exemption to the typically wealthy investors whose effective marginal income tax rates are usually 28 to 40 percent. For state governments, the taxable option could help their revenues as well. It works as long as the reimbursement rate of the direct subsidy is lower than the effective average tax rate on that issuer's muni bonds.

So what's the next step?

The public finance community, the public pension funds and their lobbyists on Capitol Hill have to step up to make this happen.

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BY PENELOPE LEMOV | NOVEMBER 13, 2014

plemov@governing.com