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Fitch: Pension Obligation Bonds Won't Fix U.S. Public Pensions.

Fitch Ratings-New York-13 August 2015: Pension obligation bonds (POBs) will not correct unsustainable benefit and contribution practices and are not a form of pension reform, Fitch Ratings says. Issuing POBs is neutral for some governments' credit quality and negative for others. In our view, credit quality is tied to whether governments implement reforms to make their underlying pension obligations sustainable over time.

The Kansas Development Finance Authority's \$1 billion POB issuance this week is the latest issuance of a financing tool often considered by governments with low pension funded ratios. The underlying question is whether they are sustainable without additional reforms to benefits and funding practices.

In the optimal scenario, POBs put cash into a troubled pension system, increasing its potential investment returns (at the assumed discount rate) and decreasing the size of annual contributions. However, this is typically neutral for credit quality because the decline in pension contributions is generally offset by higher debt service and the unfunded pension liability is replaced by bonded debt. At worst, governments using POB proceeds to cover annual contributions that normally would be paid by annual budgetary resources are engaging in deficit financing and creating a higher annual fixed-cost burden and higher liabilities. This is typically negative for credit quality. In all cases, POBs raise timing and investment risks as they are betting that investment returns will exceed the cost of debt service.

According to Thomson Reuters, governments sold \$670 million of POBs in the first half of the year, compared with \$300 million in all of 2014. The growth of these bonds was motivated by the increase in unfunded pension liabilities, which rose sharply since the significant market losses of 2008-2009.

However, those market losses are not the only cause of weakened pensions. The majority of plans lowered benefits and/or raised contributions in response. Fitch expects slow improvements in funded ratios for most plans as reduced benefits usually apply only to new workers and stronger contribution practices accrue in the form of larger pension investment portfolios. A handful of governments have been unwilling or slow to change benefits or to correct historically inadequate contribution practices that now require much higher contributions. For those pension plans, any gains from issuing POBs will be temporary in the absence of more fundamental reforms.

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The above article originally appeared as a post on the Fitch Wire credit market commentary page. The original article, which may include hyperlinks to companies and current ratings, can be accessed at www.fitchratings.com. All opinions expressed are those of Fitch Ratings.

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