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Pension Obligation Bonds May Soon Have Their Moment.

Issuing bonds to wipe out unfunded liabilities is risky. For some municipalities, it might soon be worth a shot.

In some corners of the finance world, the phrase "pension obligation bonds" is practically a four-letter word. The debt, which raises money to plow into public retirement systems, is deemed risky and dangerous, nothing more than a gamble on future market moves by state and local government leaders who are too clever for their own good.

It's true that some of the most infamous municipal bankruptcies, from Detroit to the California cities of Stockton and San Bernardino, involved pension obligation bonds, or POBs. Indeed, an oft-cited study by the Center for Retirement Research at Boston College found that "the jurisdictions that issue POBs tend to be the financially most vulnerable with little control over the timing." Chicago, which has a junk rating from Moody's Investors Service, floated the idea of using POBs last year.

That kind of deal would be asking for trouble. For one, Chicago pays a hefty premium to borrow, making it tougher for investment returns to exceed the bonds' fixed interest rate and turn the financing into a victory. Also, the city would be buying into a stock market that remains close to all-time highs, just as concerns about a potential economic slowdown are reaching a fever pitch. It doesn't add up.

But consider a scenario 12 months from now in which the U.S. economy enters a recession. That's hardly a bold call: A Federal Reserve Bank of New York model in August put the odds at 1 in 3.

In such an environment, equities, which have become the cornerstone of public pension plans, will likely have slumped as corporate earnings suffer and consumers close their wallets. Benchmark U.S. Treasury yields, already near all-time lows, will head even closer to zero as investors seek safety.

Would POBs make sense financially at that point? Absolutely.

Take South Carolina. As of 2017, its pensions were 54.3% funded, the sixth-worst level in the nation. And yet it maintains a pristine triple-A bond rating from Moody's, so the yield on its 30-year tax-exempt debt is a measly 2%.

Now, POBs must be taxable securities, after the Tax Reform Act of 1986 closed a loophole that exploited an almost risk-free opportunity for states and cities to sell tax-free debt and buy higher-yielding Treasuries. So for South Carolina, that yield would have to be higher. Still, even if the state could borrow at 3%, is there really much doubt that a broad basket of public stocks, not to mention hedge funds and private equity firms, will beat that mark in the coming decades? From the height of the dot-com bubble in early 2000 until now, the S&P 500 has returned on average 5.4% annually. Since March 2009, it's delivered 17.5% a year. Adding in an allocation to the Bloomberg Barclays U.S. Aggregate Bond Index over either of those periods still leaves returns comfortably above the going rate on U.S. state obligations.

If this sounds like market timing, that's because it is. And with prudent management—and under the right conditions—it's not so much a gamble as an automatic stabilizer.

These massive funds have trillions of dollars in assets and depend on sustained market gains to meet their promises to retired public employees. recession is precisely the time for those focused on the long term to buy risky assets on the cheap. Yet that's exactly when states and cities see tax revenue dry up, affording them little room to ramp up investing. Instead, as they did during the last downturn, governments are inclined to skip pension payments as they grapple with budget shortfalls.

Matt Fabian, a partner with independent research company Municipal Market Analytics, could be called a POB skeptic. He published a report this year with a section titled "Fourteen Pension Obligation Bond Problems." But even he sees some merit in them when they're managed properly. "If there's a correction in the stock market, and you can time it at the bottom, sure," he says. "But think about the political will at that point. That's when you do it, but that's also when you don't do it."

It's true that austerity is still a virtue in many statehouses, unlike at the federal level. But financial advisers should have no trouble doing the math and coming up with scenarios in which selling POBs and investing in a mix of stocks and bonds would be a windfall with a high degree of confidence. Nothing is certain, of course, but using historical performance as a guide is at least informed speculation rather than an outright gamble.

Even when a positive spread between investment returns and the securities' interest rate is all but ensured, opponents of POBs may still have some valid criticisms. For one, issuing the debt is not a substitute for making required contributions. As Fabian points out, "pension bonds are rarely done to help the pension—they're done to help the budget." POBs should be considered a way to go above and beyond typical funding at an opportune time, when the prospects for future gains are greatest.

Another concern is that the transaction substitutes pension debt for comparatively inflexible muni bonds. The Government Finance Officers Association notes that POBs often restrict the option for borrowers to "call" the debt, "which can make it more difficult and costly to refund or restructure." The GFOA also correctly points out that the structures are sometimes tied to swaps and derivatives, and these can get messy. A plain-vanilla approach is the way to go.

In a blunt statement on its website, the GFOA says it "recommends that state and local governments do not issue POBs." Nothing indicates it plans to alter that stance anytime soon. That sort of warning could deter fiscally sound governments from even considering them when the going gets tough.

Moody's takes a somewhat more flexible position. "Our view is the issuance of POBs at the time of the transaction is really credit-neutral," says Tom Aaron, a public pension specialist at the credit-rating company. "But context matters a heck of a lot in terms of whether these things pan out."

In particular, "if the government continues making its full contributions, that's a different story than using the pension bonds as a temporary budget reprieve, because that turns it into an arbitrage play plus deficit financing," Aaron says. Of course, history has shown that's a big "if."

One thing that's different today is the stark drop in nominal bond yields vs. the end of the last recession. In June 2009, benchmark 30-year tax-free munis yielded about 5%. Now they yield a record low 2%. The GFOA calls POBs "very speculative," but they present a much lower hurdle with interest rates so suppressed.

One need only look at Illinois, which has the worst-funded state pension in the U.S. after years of skipped payments, to see how important it is to funnel money into retirement systems at the right time. Earlier this year, the state resorted to issuing POBs with a top yield of more than 6%. The S&P 500 would hit a new record high a month later. With $134 billion of unfunded pension liabilities, it's anyone's guess whether the state can find a path to solvency. Meanwhile, New Jersey's Senate president in August claimed his state was "in worse shape than Illinois" because of its massive pension shortfall.

Fortunately, most other states and cities start from a stronger position. And though there's no magic number that defines a well-funded pension plan, clearly any sustained decline in stocks and other risky assets would leave many of them in an uncomfortable hole.

Lower-for-longer interest rates present a unique opportunity for government officials to dig out faster than before. Make no mistake—POBs are not a cure-all. But layered on top of required payments, they just might help defuse the ticking pension time bomb that seems destined to explode.

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