Bond Case Briefs

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Forget Pension Obligation Bonds. Two Cities Are - No Joke - Leasing Their Streets To Fund Pensions.

It sounds preposterous, and the headline of a recent article here at Forbes by Marilyn Cohen is certainly eye-catching: "The Lunacy Of Using City Streets To Collateralize New Municipal Bond Deals." And these aren't just any municipal bond deals — two cities in California are issuing bonds *with their own city streets as collateral* to pay down their unfunded pension liabilities.

In West Covina, the city council voted to do so on July 7, as reported at the *San Gabriel Valley Tribune*. The city, a suburb of Los Angeles with a population of 100,000, a median household income of $71,200, and nearly $200 million in pension liabilities, is using the proceeds of $205 million in debt to pay off its own debt to CalPERS.

Likewise, according to the *East Bay Times*, the city of Torrance, also in suburban Los Angeles, population 150,000, median household income $80,900, pension debt $500 million, will issue $350 million in bonds. (See the formal report of the recommendation and the minutes of the July 28 city council meeting.)

Now, it turns out, they're not turning their streets into toll roads, or giving bond-buyers the ability to "foreclose" or take control either now or in the future.

They're using a bond-issuing mechanism called "lease revenue bonds." We're all used to cities paying for public works, stadiums, and the like by issuing bonds which are paid off by a dedicated revenue source — sewer bills, hotel taxes, etc. But lease revenue bonds are different. Here's the layperson's description at Charles Schwab:

> "Lease revenue bonds are a unique structure in the muni market. Instead of issuing long-term debt, like general obligation bonds do, to finance improvements on a public facility, the municipality may enter into an arrangement that uses lease revenue bonds. Often a trust, not the municipality, issues bonds and generates revenues to pay the bonds back by leasing the facility to the municipality. The municipality will generally appropriate money during each budget session to meet the lease payment.
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> "Bonds backed by structures with lower essentiality and limited protections for appropriating funds will usually be lower-rated and have higher yields. Our opinion is to be cautious of bonds backed by lease revenues, as these bonds should be viewed more like general government bonds, not revenue bonds."

This means that the city of San Francisco used lease revenue bonds to buy items ranging from hospital beds to a witness protection van. And Torrance and West Covina are each using these bonds to, in principle, lease their city streets to a special Financing Authority, which will pay the city their up-front money, and "rent" the streets back to the city for the 25 year term of the agreement, in order to pay off the bonds.

Despite the fact that the streets are nominally being "leased," the bondholders will not have any particular rights to lay claim to the streets; despite their status as "collateral," the bondholders can't take them over and charge tolls if either city defaults on their "rent" payments. The city will simply pay the "rent" based on their ordinary tax revenue rather than any special purpose taxes. The "lease" component then becomes little more than a gimmick, a loophole, a way to use the existing "menu" of bond choices available to them in the most advantageous way possible, especially since, at least in California, "general obligation bonds" require voter approval.

(Lease revenue bonds exist at the state level, too; and a group opposing the construction of prisons has a helpful explainer on these due to their use for that purpose.)

What, then, is the purpose of a lease revenue bond in this case? *The Bond Buyer* explains that these are functionally pension obligation bonds, but can be implemented more quickly, citing Mike Meyer of NHA Advisors: "Depending on the legal structure, there may be added flexibility for use of proceeds to CalPERS or more strategic timing of investing in the market. . . . These things aren't possible under a traditional POB structure." At the same time, there's a trade-off, as rating agencies rate pension obligation bonds more highly than lease revenue bonds. Brian Whitworth, director of Hilltop Securities, which underwrote the West Covina bonds, further claimed, "This is the fastest form which the city would be able to use and issue bonds."

And why are the cities in such a hurry to issue these bonds? In one respect, it's the same rationalization as appears every time pension obligation bonds pop up, the notion that they are "refinancing" a debt at a lower interest rate, because of the difference in rates between the bond rate, and the interest being accrued on the books, at the higher actuarial valuation rate — so, for example, a 7% rate appears to be dropped to a 4% rate due to the "savings" of "refinancing." (See my explainer from 2019, when this was a hot topic in Chicago.) This is a mirage, though — since it's all just a matter of how liabilities are accounted for; their true cost is the payment of pension benefits in the future, regardless of what the plan account is now. And the nature of a pension obligation bond, the hope to get a higher asset return for the money you've borrowed at a low bond rate, remains the same.

Now, to be sure, there is a further wrinkle in California. The state agency CalPERS manages their pensions, and prescribes a required annual contribution. This makes it all the more difficult to perceive that pension bonds' "savings" come solely from the hope of higher asset returns than bond interest rates (which are, incidentally, fully-taxable rather than offering the investors the benefit being of tax-free).

And what are those annual contributions? The most up-to-date reports on the CalPERS website are from July 2019, based on June 30, 2018 and calculating the required contributions for the 2020 – 2021 plan year. The city of West Covina pension plan is 71% funded, but to pay down its underfunding and fund new accruals, must pay 44% of payroll. The West Covina public safety plan is 62% funded and requires a contribution of 74% of payroll to fund new accruals and pay down underfunding. The Torrance city pension is 79% funded with 24%-of-payroll contributions; the Torrance fire pension, 65% funded, 68%-of-payroll contributions; and the Torrance police pension, 62% funded, 78% of payroll contributions. What's also important to know is that these high contributions are not the result of having to make up underfunding in an unreasonably-short period of time; the underfunding level as of 2008 was set at a 30 year amortization, and gains and losses since then are likewise given 30 years to be paid off. This means that the high contributions are simply a reflection of the high cost of the pensions themselves, and the tremendous impact of even marginally-poor funding levels.

Forbes

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Sep 2, 2020,03:44pm EDT