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Pension Obligation Bonds: A Prudent Investment or a Speculative Venture?

The issuance of Pension Obligation Debt has been a topic of contention amongst various local and state government officials, municipal advisors, local politicians and their constituents.

In the recent years, the Government Finance Officers Association (GFOA) came out with a stern advisory for local and state governments to NOT issue pension obligation bonds (POBs) to meet their unfunded liabilities and made a case for them being "complex instruments that carry considerable risk." It's also important to note that some of the large municipalities that filed for bankruptcies in the United States had some exposure to pension obligation debt – including the City of Stockton and City of San Bernardino – in the years leading up to their insolvencies.

In this article, we will take a closer look at the composition of pension obligation debt, and how it can impact the financial picture of a local or state government.

Rising Unfunded Pension Liabilities for Local Governments

As we dive deeper into the composition of pension obligation bonds, it's important to understand the reasoning behind their issuance by local and state governments.

In the United States, almost all of the local and state governments partake in some sort of state-sponsored pension plans, i.e., CalPers (California Public Employee Retirement System) for the State of California. These pension plans work with all participants – local and state governments – to assess and analyze their pension liabilities. Primarily, these pension liabilities are based on a few factors: retirement age, mortality, projected salary increases attributed to inflation, across-the-board raises and merit raises, increases in retirement benefits, cost-of-living adjustments, valuation of current assets, investment return and other matters.

One of the biggest challenges and largest variables in the aforementioned list of factors is the investment return on the pension portfolio; this single variable is also responsible for creating the large unfunded liabilities for many of the local governments.

Let's take a look at that in detail: when a pension fund, like CalPers, determines the annual pension liability for a local government, it makes a few assumptions in its calculations and one of them is being the pension fund's forecasted investment return for the upcoming years. For example: a pension fund assumes an investment return of 7% for the year and bases its actuarial pension obligations for local cities and counties; however, the financial markets had a terrible year and the pension fund only generated 2% returns – this means that the 5% gets added to the unfunded liabilities portion for cities and counties – because that money, originally expected to be generated through investment returns, is still needed to fully meet the pension obligation for city and counties. Furthermore, when the pension fund decides to lower their discount rate, or the investment return projections, it adds to the pension liability for the participants. In recent years, this has been a large area of concern for many of the municipalities throughout the United States.

This is where local and state governments resort to POBs.

The Issuance of Pension Obligation Bonds

POBs are taxable forms of debt that are issued to address/meet the unfunded pension liabilities as part of the overall financial strategy for local and state governments.
The basic assumption with POBs is that a local government can access the capital markets to raise funds at a lower interest rate to meet its pension obligation, which can generate a higher investment return. This way, the pension obligations are met and investment returns are higher than the debt service required on the bonds.

"What can go wrong in this assumption?" is the key to understanding the risk with POBs:

- The first and largest risk is the inability to meet the targeted investment returns. The financial collapse of 2008 was a prime example of this risk. With the stock market's decline, the invested POB proceeds will fail to earn more than the interest rate owed over the term of the bonds, leading to a scenario that will double the financial strain for any local and state government. They will not only have to pledge their revenue sources to make the debt service payments on the POBs, but also get stuck with unfunded pension liabilities, because of inadequate pension fund returns generated during a stock market downturn.
- Furthermore, the taxable form of pension debt is often secured by some sort of revenue sources, like sales tax or property tax, which means that the issuance of this debt cuts into a municipality's debt capacity that could be used for other purposes. Issuing taxable debt to fund the pension's liability increases the jurisdiction's bonded debt burden, and potentially uses up debt capacity that could be used for other purposes. Also, the taxable form of debt is often issued without a call option, which makes it hard for a municipality to refund the debt at a lower interest rate in the future.
- Another important point to note here is the prolonged nature of recession. Similar to 2008, an economic downturn often takes years before financial markets start returning to a relative state of normalcy. With that, if a municipality has POB issued to meet its unfunded liabilities, a prolonged recession will exacerbate the financial strain by many folds – seen in the cases of large municipal bankruptcies in California.

The Bottom Line

The unique nature of POBs – and how they flow through a municipality's financial strategy – makes it riskier than other forms of debt, and the timing of their issuance plays a huge role in the success of their intended use. Furthermore, any decline in the financial markets will certainly increase the fiscal strain for municipalities with outstanding pension obligation debt.

For investors, it's important to understand the taxable status of these bonds and also the credit risk associated with their issuance.

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