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# Perspectives on Pension and Retiree Health Obligation Bonds

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## About This Material

**This material represents the combined perspectives of Hewitt Associates, The Segal Company and Deloitte Consulting**

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## Pension Obligation Bonds: Overview and Background

- Overall purpose of POBs is to allow governmental/public plan sponsors to:
  - Issue fixed obligation debt instruments and invest proceeds
  - Reduce overall unfunded liability on assumption that yield on assets will exceed cost of bond payments
- First POBs issued in mid-1980 were tax exempt (rendering it easier to achieve positive spread between return on purchased assets and bond service)
- After 1986 change to federal tax law (rendering POBs taxable) POBs have been issued in several “waves” in early 1990s and early 2000s; offerings were attractive to foreign investors
- Assessment of POBs reflects a combination of financial analysis and more subjective beliefs about risk and governance

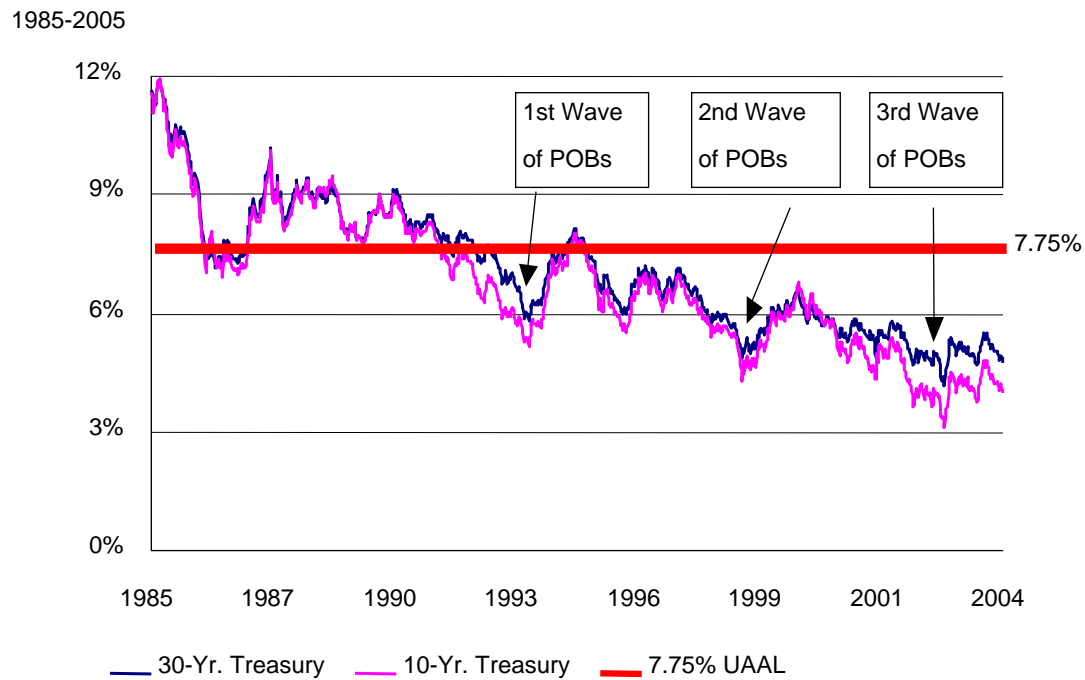
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## Overall Current Environment

- POBs are assessed by comparing pension discount rate (representing anticipated return on invested assets) and bond service costs
  - Government pensions tend to have higher discount rates and more stable rates of annual contributions (thus favoring use of POBs)
  - Bond costs are sensitive to interest rate payable by issuer; current market has not favored POBs (resulting in a lull of issuances)
- Waves of POB issuance have, generally, occurred when anticipated spread between asset returns and bond costs exceeded 150-200 basis points (1.5-2 percentage points)
  - In early 2000's wave, projected asset returns of 7.75%-8% and bond costs of 5.75%-6% met this (informal) threshold
  - When discount rate/bond cost spread is favorable it is possible for investment bankers to generate modeling showing >90% likelihood that return on assets will exceed cost of bonds

# POB Issuance and Interest Rates

## Benchmark Treasuries vs. Typical Pension Fund Investment Rate



Citigroup presentation to City of Oceanside, City Council Pension Obligation Bond Workshop, July 13, 2005

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## General Considerations

- POB assessment requires use of long time horizon (reflecting bond duration)—generally 20-30 years; actuarial analysis indicates a 25-30 percent possibility that asset returns will not achieve a spread of 200 basis points over debt payments
- POB leverage increases overall contribution volatility for the combined cost of debt service and pension contributions
- Even when modeling shows high likelihood of favorable outcome, POB success is heavily impacted by timing; it becomes more difficult to achieve positive net return if there is a steep market decline in first few years after issuance
  - For example, 20 percent decline in year 1 (of 20-year period) can eliminate 150 basis point spread on remaining 19 years
- Post-mortems on prior POBs are premature; real value/cost will not be known until bonds mature

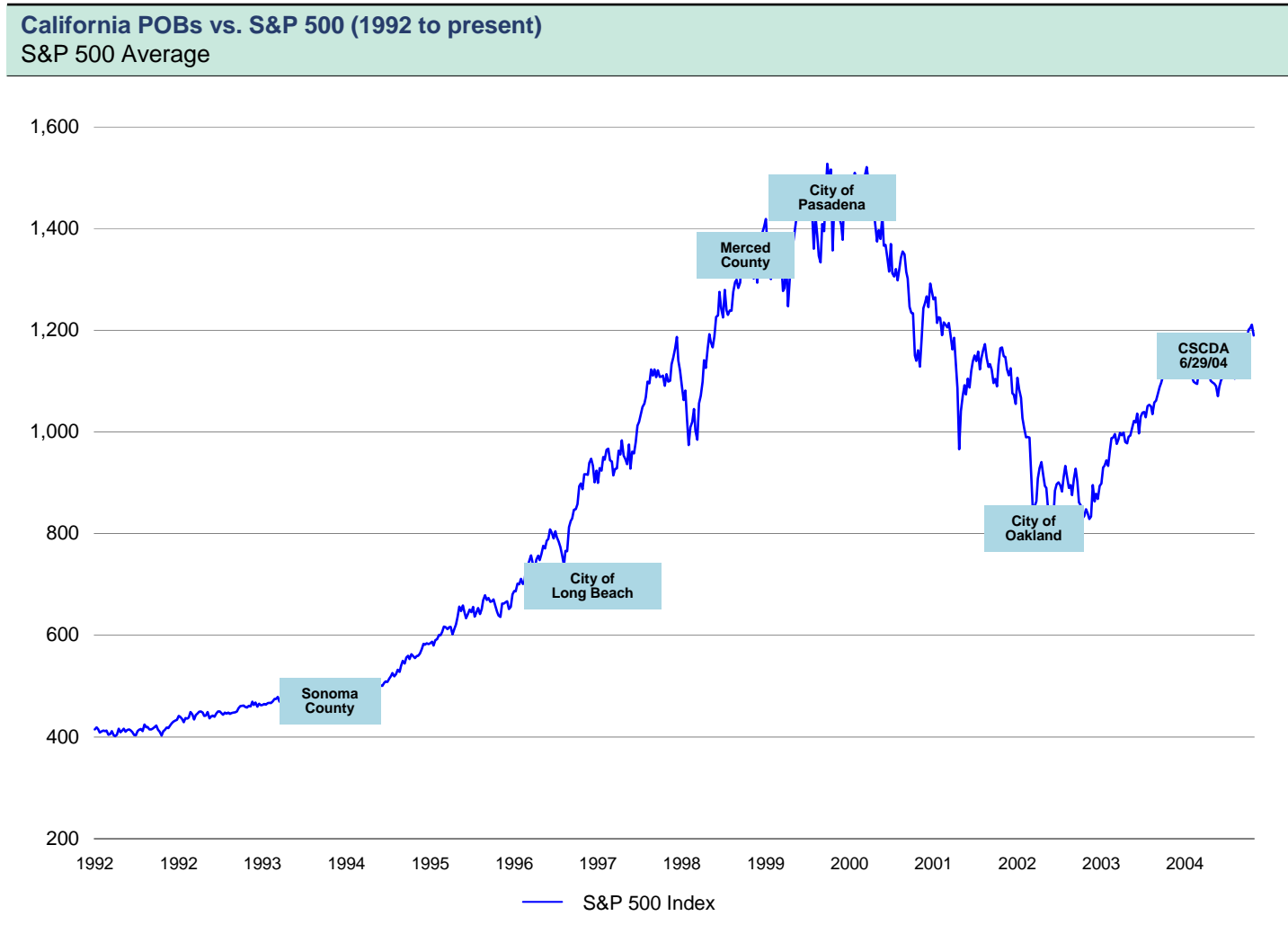
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## California

- California has been a leading state in issuance of POBs
  - California Statewide Communities Development Authority (CSCDA) program to support prefunding of CalPERS UAAL by municipalities through use of POBs
  - Size and professional management of counties, municipalities and other units of local government has also been conducive to use of POBs in California

# Market Timing: Some California Bonds

- ▣ POBs sold before 1999 generally had large actuarial gains from above average investment returns
  
- ▣ Those sold after 1999 are dealing with “new” actuarial liabilities on top of the “new” POB debt service



Source: Presentation by David Brodsky to California Society of Municipal Finance Officers, Feb 2005

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## Additional General Considerations

- Subjective considerations and positions complicate impact of financial analysis
- Several additional principles cited in POB discussions:
  - POBs should not be used to attain 100% funding out of concern of creating long-term excesses; attainment of 80%-90% funded levels seem to be more favored;
  - POBs should be focused on UAAL and not substitute for current contributions or other short-term requirements;
  - Impact of POB on overall bonding authority/capacity of issuer must be addressed

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## POB: Frequently Raised Concerns

- Additional concerns cited in POB discussions include the following:
  - Fixed nature of debt repayments reduces funding flexibility (converts “soft” obligation into a “hard” obligation)
  - Large inflow of assets can increase market timing risk
  - In addition to POB leverage, increase in funded status resulting from POB proceeds will increase contribution volatility (as a percent of payroll)
  - If short term cash outflows exceed regular contributions to plan, issuer may need to prematurely liquidate positions (undermining rationale for POBs)

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## Potential Use of POBs by University of California

- ▣ Specific circumstances at University of California merit consideration of alternative approaches to the uses of POBs
  - Can POBs be issued to finance State contribution to pension plan, thereby allowing University to obtain contributions from other funding sources?
  - Does funding provide negotiation tool in the collective bargaining process?
  - Should the University pursue POBs to cover multi-year state funding obligations?

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## Questions on the Use of Pension Bonds by University of California

- Who issues bonds? What are the pros and cons specific to the University in current environment (i.e., credit rating, and overall financial health)?
- If the University issues POBs to cover the State contribution for several years (i.e., approximately \$400 million):
  - What is impact on University financials?
  - What are the rating agencies looking at?
- If the University issues bonds:
  - Does that affect funding negotiations between University and State?
  - Can the University obtain a commitment from the State to make regular payments reflecting bond payments?
- If bonds issued to cover State annual contributions (and capture other funding sources), can bonds be issued in single tranche or are annual issuances required? Annual issuances would increase transaction costs

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## Retiree Health Obligation Bonds

- Impetus for retiree health bonds is more recent (GASB 45) and few such bonds actually issued to date
- Retiree health bonds are (conceptually) similar to pension obligation bonds—but with some key differences
  - Establishment of dedicated funding sources (including—but not limited to—POBs) reduces accrued liability (due to ability to use a higher discount rate when valuing liabilities)
  - Retiree health benefits represent a “softer” liability than pension that is converted to a “hard” liability as a bond
  - Retiree health liabilities have higher volatility than pension liabilities due to health trend and potential for legislation
  - Retiree health bonds often represent sole prefunding effort (unlike pensions, where POBs are adding to existing prefunding)

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## Retiree Health Obligation Bonds

- Favorable GASB treatment available for funding the UCRHBT over time or through POBs
  - Full funding is not a requirement
  - Partial funding provides some GASB treatment benefits
- Funding over time reduces volatility – contribution rates can react to annual changes in health costs and legislation
- Early adopters of prefunding Retiree Health benefits in the public sector have generally chosen to:
  - Set high funding target (e.g., 100 percent of liability), and
  - Fund over extended period of time (20-30 year period)
- The State of California proposed an alternative goal of funding the Normal Cost, initially

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## Appendix: Pension Obligation Bonds

### *Largest Users*

- ▣ New York
- ▣ California

### *Largest Individual Issues*

- ▣ Illinois (2003): \$10 billion
- ▣ Puerto Rico (2008): \$2.9 billion
- ▣ New Jersey (1997): \$2.8 billion
- ▣ Connecticut (2007): \$2.0 billion
- ▣ Alaska (\$5 billion authorized; still under consideration): \$2.0 billion
- ▣ Chicago Transit Authority (2007): \$1.9 billion

# Appendix:

## POB Issuance in California to Finance UAAL (1995-2005)

### POB Issuance By California Cities Since 1995

Sale Date	Issuer	Issue Description	Amount (\$ mils)
7/28/1995	Santa Rosa-California	Pension Obligation Bonds	8.67
10/25/1995	Long Beach City-California	Pension Obligation Bonds	108.64
2/14/1997	Oakland-California	Pension Obligation Bonds	436.29
5/19/1998	Berkeley-California	Pension Obligation Refunding Bonds	12.42
7/29/1999	Pasadena-California	Pension Obligation Bonds	101.94
11/3/1999	Richmond City-California	Pension Obligation Bonds	36.28
7/11/2000	Fresno-California	Pension Obligation Refunding Bonds	211.30
6/13/2001	South Gate City-California	Taxable Certs of Participation	8.50
10/3/2001	Oakland-California	Pension Obligation Bonds	195.64
1/23/2002	Fresno-California	Pension Obligation Bonds	205.34
8/9/2002	Long Beach City-California	Pension Obligation Refunding Bonds	87.95
7/9/2003	Santa Rosa-California	Pension Obligation Bonds	50.67
6/17/2004	Union City-California	Pension Obligation Bonds	23.00
6/29/2004	Pomona City-California	Pension Obligation Bonds	38.00
1/20/2005	Fairfield City-California	Pension Obligation Bonds	29.92
3/1/2005	South Gate City-California	Pension Obligation Bonds	24.40
4/13/2005	Fairfield City-California	Pension Obligation Bonds	11.83
6/13/2005	Huntington Park City-California	Pension Obligation Bonds	23.05

Source: SDC Thomson Financial

Source: City of Oceanside Presentation; Obtained from California Society of Municipal Finance Officers web site