CITY OF MILWAUKEE
COMPTROLLER

Introduction to Pension Obligation Bonds

Background

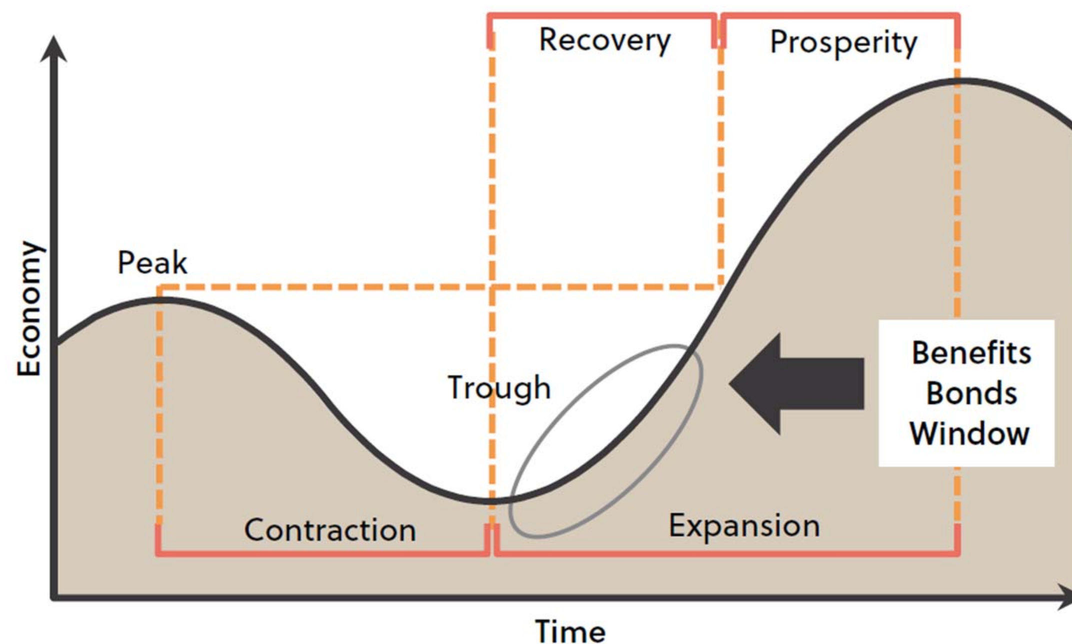
- Pension Obligations Bonds (POBs) are taxable bonds issued to increase funding in a pension plan.
  - Bond proceeds are invested within the pension fund as plan assets.
- Plans use the assumed rate of return on pension plan assets as the discount rate (7.5% for the City of Milwaukee).
- This provides the potential to earn more on the bond proceeds than is paid in bond interest. For example:
    - Borrowing rate of 4.5%
    - Target earnings of 7.5%
  - If actual returns exceed the borrowing rate, these savings can potentially become real.
  - However, savings are not guaranteed and have not always been achieved by POB issuers.

Pension Obligation Bond Math

- POBs are a financing strategy that involves the cost of bond financing and the long-term return on investment.
- Long-term investment rates that are greater than borrowing costs will achieve net benefit to the system. Note - if the rate of return is lower than the discount rate, the originally projected funding target may not be reached. This risk is present regardless of the POB.
  - If the pension fund does not earn 7.5% annually, the fund will not be 100% funded after repayment (assuming the entire unfunded liability was funded with the issuance of POBs).
- The debt service on the POBs is compared to the UAL amortization payment amount of the annual contribution in evaluating POB issuance.
- The City is required to pay the annual normal cost of the pension plan regardless of whether POBs are issued.
  - Approximately $62 million currently.

Pension Obligation Bond Math

- While low interest rates are part of the equation for a promising benefits bonds issuance, the more important part of the equation has historically been the investment rate.
- Investment of POB proceeds should occur at cyclically low market levels in order to maximize benefits (referred to as the "benefit bonds window").
- The first few years of returns after issuance have the highest impact on profitability.



ERS Plan Returns

- The below chart shows the actual returns for the City's pension plan, net of fees.

Milwaukee ERS Annual Returns
with 5 year and 20 year Rolling Averages

35%
30%
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
-25%
-30%
-35%

1990 1995 2000 2005 2010 2015 2020

Pension Obligation Bond Considerations

- POBs, though an attractive option on the surface, carry many issues that should be properly addressed.
- In order to be most effective, POBs must be part of a long-term, comprehensive strategy.
- Future underfunding of contributions by the issuer will diminish impact of POBs.
- POBs are a long-term strategy and the true results can only be known once the deal has been repaid.
  - Short-term views of the POB strategy can show perceived success or failure based on market conditions at the time of evaluation.
- Even if executed with a thoughtful and well managed issuance and investment strategy, POBs will still have a negative connotation with some audiences.
  - The Government Finance Officers Association (GFOA) recommends that governments should not issue POBs (discussed later in this presentation).

Pension Obligation Bond Risks

- Conversion of a soft liability to a hard liability.
  - Often stated as a risk, however under the City's current pension structure, the required contributions act more as a hard liability because the City is legally obligated to make them in full.
- Issuance timing.
  - If POBs are issued at a market peak, the earnings on the proceeds could be less than the interest paid.
- Debt load and capacity.
- Ratings impact.
- Limits ability to provide benefit enhancements while POB debt is outstanding.

Rating Agencies Views on Pensions

- Numerous rating agency metrics explicitly factor in pension liabilities, and incorporate current and potential future burden of benefits into their process.
- Policies that risk unsustainable future payments or lack a responsible long-term approach to an appropriate funding level will be viewed as credit negatives.
- Moody's and Fitch now apply standardized assumptions to compare pension liabilities and budgetary costs.
- Standard & Poor's hired an in-house actuary to conduct detailed analysis into pension liabilities and assumptions.
- The heightened focus of rating agencies on pension funding and funding levels have created downward pressure on ratings for entities with stressed pension systems.
- Rating agency reports have drawn attention to the current pension funding levels.
- The rating agencies generally view issuance of POBs as credit neutral or credit negative, however, larger structural changes to the pension plan could be viewed in a positive light.

GFOA Stance

- GFOA currently recommends that municipalities do not issue pension obligation bonds for the following reasons.
  - The invested POB proceeds might fail to earn more than the interest rate owed over the term of the bonds, leading to increased overall liabilities for the government.
  - POBs are complex instruments that carry considerable risk. POB structures may incorporate the use of guaranteed investment contracts, swaps, or derivatives, which must be intensively scrutinized as these embedded products can introduce counterparty risk, credit risk and interest rate risk.
  - Issuing taxable debt to fund the pension liability increases the jurisdiction’s bonded debt burden and potentially uses up debt capacity that could be used for other purposes. In addition, taxable debt is traditionally issued without call options or with "make-whole" calls, which can make it more difficult and costly to refund or restructure than traditional tax-exempt debt.

GFOA Stance - continued

- POBs are frequently structured in a manner that defers the principal payments or extends repayment over a period longer than the actuarial amortization period, thereby increasing the sponsor's overall costs.
- Rating agencies may not view the proposed issuance of POBs as credit positive, particularly if the issuance is not part of a more comprehensive plan to address pension funding shortfalls.

- GFOA's concern seems to relate to the complexity and size of POB borrowings, and whether an infrequent issuer of debt has the expertise to evaluate and manage the risks.

City of Milwaukee Requirements

- The issuance of POBs for the City would require enabling legislation at the State level.
  - Previously approved for MPS and Milwaukee County.
- Issuance would require appropriation bonds because general obligation debt capacity is limited to 5% of equalized value.
  - Subject to annual appropriation.
  - Less attractive to investors than general obligation bonds.
  - Issued through RACM.
  - Would likely require pledge of state aid and the state's moral obligation pledge.
- Timing depends on how quickly authorizing legislation would be approved at the state level.
  - When enabling legislation passed, bond issuance would require an additional 3-4 months.
  - Need all approvals in place in order to monitor for next "benefit bonds window".

Closing Thoughts

- POBs are not a “silver bullet” solution to the pension funding problem.
  - Without a broad approach that seeks to address the multiple facets of an underfunded plan, the City could be in largely the same situation after the debt is repaid.
- Plan design changes (including review and update of actuarial assumptions) should accompany (and preferably precede) POBs in order to comprehensively address the structural imbalance.
- POBs on their own may not provide a great deal of budgetary relief. Normal cost must still be made each year, in addition to the POB debt service payment.
- “Governments should think of benefits bonds as another option in their funding strategy — not the only one.” - from PFM Special Report “Benefit Bonds: Not (Quite) Dead Yet, Considerations for Pension Obligation and OPEB Bonds”, May 2016.