



ADVISORY

A GFOA *advisory* identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Evaluating the Use of Pension Obligation Bonds (1997 and 2005) (DEBT & CORBA)

Background. An unfunded actuarial accrued liability (UAAL) for pension benefits generally represents the difference between the present value of all benefits estimated to be payable to plan members as a result of their service through the valuation date and the actuarial value of plan assets available to pay those benefits. This amount changes over time as a result of changes in accrued benefits, pay levels, rates of return on investments, changes in actuarial assumptions, and changes in the demographics of the employee base.

State and local governments normally reduce their unfunded actuarial pension liability over time as part of their annual required pension contribution. Some governments, however, have elected to issue pension obligation bonds to reduce their unfunded actuarial liability as a part of the overall strategy for managing its pension costs. Governments should also realize that, while the UAAL may initially be fully funded, actuarial experience may result in over or under funding over time. Policies should be developed to manage potential over or under funding, regardless of the issuance of POBs.

Pension obligation bonds must be issued on a taxable basis because current federal tax law restricts the investment of the proceeds of tax-exempt bonds in higher-yielding taxable securities. From a purely financial perspective, issuing pension obligation bonds can produce savings for a government if the interest rate paid on the bonds is less than the rate of return earned on proceeds placed in the pension plan. However, governments issuing pension obligation bonds must be aware of the risks involved with these instruments and have the ability to manage these risks.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local governments use caution when issuing pension obligation bonds. Governments should ensure they are legally authorized to issue these bonds and that other legal or statutory requirements governing the pension fund are not violated. Furthermore, the issuance of the pension obligation bonds should not become a substitute for prudent funding of pension plans.

Governments issuing pension obligation bonds should compare the bond's debt service schedule to the pension system's current UAAL amortization schedule, using the true interest cost of the bond issue as the discount rate to calculate the estimated net present value savings. Additionally, issuing governments should consider the amount of the estimated net present value savings, the spread between the true interest cost of the bonds, and the actuarial investment return assumption of the pension plan.

Even if the analysis indicates that financial benefits appear to outweigh the risks, governments should evaluate other issues that may arise if the bonds are issued, such as the loss of flexibility in difficult economic times because of the need to make timely payments of principal and interest in order not to default on the bonds, potential misunderstanding by policy makers regarding the possibility that an unfunded liability may reappear in the future, and potential pressures for additional benefits by government employees if plans are fully funded and the government's contribution as a percentage of payroll has declined relative to neighboring jurisdictions.

Before deciding to issue pension obligation bonds, a governmental entity should undertake a careful financial analysis that considers the following:

- Adequate disclosure of the fact that even if bonds are sold, governments could still face an unfunded liability in the future resulting from such factors as changes in benefit levels, investment returns, demographics, or other factors that were not anticipated when THE bonds were issued.
- Pension obligation bonds should be structured in a manner that does not defer principal payments. Additionally, the bonds should not have a maturity that is in excess of the current unfunded actuarial accrued liability amortization period.
- Most pension systems have investment practices that are designed to accept smaller incremental contributions than are typical with pension obligation bonds. A review of the system's ability to adequately incorporate a much larger contribution into the system without adversely affecting the system's asset allocation should be considered.
- Issuance of debt to fund pension liability increases debt burden and may use up debt capacity that could be used for other purposes.
- Issuing pension obligation bonds converts a liability that may not be fully reported on the face of the financial statements (i.e., the unfunded actuarial accrued liability) into a liability that is reported on the face of the financial statements (i.e., bonds payable).
- Governments should ensure that the pension system review its cash flow in order to ensure that benefits are paid in a timely manner, since annual employer contributions will be reduced in lieu of debt service payments on the POBs. Analysis should extend through the amortization period of the unfunded liability on a cash flow basis and the debt service period of the POB.
- Special consideration and analysis should be given to the actuarial and cost implications for individual employers participating in multiple-employer systems.

References

- *Financing Retirement Systems Benefits*, Richard G. Roeder, Public Employee Retirement Series, GFOA, 1987.
- "Pension Obligation Bonds: Practices and Perspectives," *Government Finance Review*, GFOA, December 1996.
- "Risky Business? Evaluating the Use of Pension Obligation Bonds," *Government Finance Review*, GFOA, June 2003, pp. 12-17.

Approved by the GFOA's Executive Board, March 2005.