House Pension & Benefits Committee

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PENSION FUNDING BONDS

- In recent years, states and local governments have issued approximately $105 billion in taxable pension bonds to make deposits to underfunded pension systems. States that have recently issued pension bonds include California, Illinois, Connecticut, Wisconsin and Oregon.

- Most Pension Funding a/k/a Pension Obligation Bonds are issued as taxable bonds, meaning that the interest on the bonds is included in gross income for federal tax purposes, although they still may be issued as state tax-exempt. Federal income tax law imposes significant restrictions on the issuance and use of tax exempt bonds, including the use of tax-exempt bonds to directly finance a deposit to a retirement plan. (The U.S. Supreme Court determined in the 1988 case, *South Carolina v. Baker* that the right to determine whether obligations issued by state and local governments may be issued as federally tax-exempt is reserved to Congress).

- This is the case because most POBs are issued for the express purpose of making a deposit of bond proceeds into a pension system account, with the goal of investing the bond proceeds in higher yielding investments, as in the following hypothetical: Bonds are issued at a 4% rate of interest, and the bond proceeds are invested in investments that over the life of the bonds returns an 8 % rate of interest, generating an internal rate of return of 4%. Congress through the enactment of the Internal Revenue Code of 1986 (the "Code") characterizes this type of bond as an "arbitrage bond", and because the proceeds are invested rather than spent as defined by tests set forth in the Code, the bonds are also characterized as hedge bonds. If the bonds are issued as tax exempt, any investment earnings higher than the yield on the bonds must be paid as arbitrage rebate to the federal government.

- Primary Uses of Pension Bonds as a Policy Instrument:

  Pension Cost Savings: POBs offer issuers an actuarial arbitrage opportunity, which, in theory, can reduce the cost of pension obligations through the investment of the bond proceeds in higher risk/higher return assets. By commingling POB proceeds with pension assets, the assumption is that the bond proceeds will return whatever the pension portfolio returns. Actuarial practice assumes public pensions will return about 8 percent. Especially in a low interest rate environment, POBS can be a compelling proposition.

Budget Relief: During periods of economic stress or constraint, governments may use POBs for budget relief. State and local governments may face legal requirements and other pressures to reduce underfunding. In periods of declining revenues, officials may see POBs as an option to address difficult fiscal challenges.

- POB Considerations:

Financial: The success of POBs depends on pension returns averaging more than the cost of financing the debt.

Timing: POBs involve considerable timing risk, as the proceeds from the issuance are invested into the pension plan portfolio. Dollar-cost averaging the proceeds in represents a more measured approach to investing large sums of money.

Flexibility: While the issuance of a POB does not change the total indebtedness of the plan sponsor, it does change the nature of the indebtedness. Requirements to amortize unfunded pension liabilities may be relatively flexible obligations that can be smoothed over time, while the POB is an inflexible debt with required annual debt service payments.