Increased Interest in Pension Obligation Bonds

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MarketWatch Blog by Alicia H. Munnell

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Even taking a nuanced view, enthusiasts should proceed with caution.

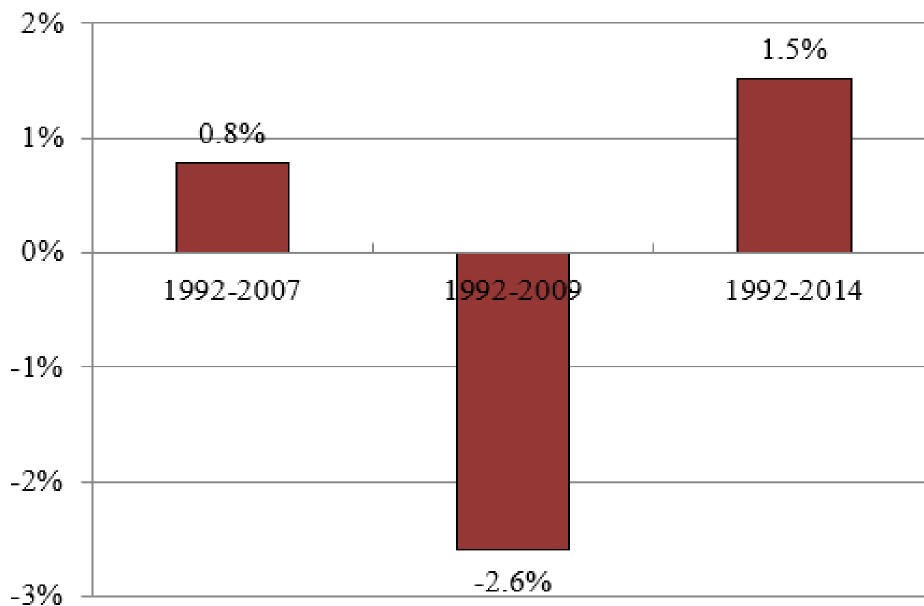
Pension obligation bonds (POBs) are in the air. Kansas, Colorado, Pennsylvania and several other states and localities have considered, are considering, or have decided upon issuing a POB to address their pension shortfalls. POBs could potentially be used responsibly by fiscally sound governments who understand the risks involved or could play a role as part of a broader pension reform package for fiscally stressed governments. (In the latter case, it seems very important to calculate the unfunded liability using a relatively low interest rate to ensure that the government borrows enough through the POB to eliminate the unfunded liability once and for all.) But our analysissuggests that POB usage to date has not followed this formula – think Detroit, which issued POBs in 2005 and 2006 just as the market was approaching a peak.

So what is a POB? A POB is a taxable general obligation bond, whose proceeds are invested in the pension trust fund. This instrument can alleviate pressure on the government's cash position by substituting for

required pension contributions, and it may offer cost savings if the bond proceeds realize a return higher than the cost of the bond. The issuance of POBs, however, poses serious risks. Pension returns may not exceed the costs of the bond, and relatively flexible pension obligations where payments can be smoothed over time become inflexible debt with required annual interest outlays.

In order to assess the performance of POBs, **we calculated the internal rate of return for all POBs issued in a given year**, based on the universe of taxable POBs through 2013. The results demonstrate the risk associated with a POB strategy. If the assessment date is the end of 2007 – the peak of the stock market – the picture looks fairly positive (see Figure 1). If assessed in the middle of 2009 – right after the market crash – most POBs appear to be a net drain on government revenues. And, as of Feb 2014, the majority of POBs had produced positive returns due to the large market gains that followed the crisis. The story is still far from over, however, since many of these POBs have a 30-year life.

Figure 1. *Average Internal Rate of Return on Pension Obligation Bonds, 1992-2007, 1992-2009, and 1992-2014*



Source: Calculations based on total monthly returns of the S&P 500 from Standard and Poor's Index Services (1992-2014); total monthly returns of U.S. Treasuries from the Ibbotson SBBI Classic Yearbook (1992-2013); and the Barclays U.S. Treasury 10-year Term Index (2014). POB data are from Bloomberg Online Service (2012); and SDC Thomson Reuters (2014).

Despite the risks, the data show that the issuance of a POB is driven not by careful planning among well-funded plans or by restructuring for sustainability among underfunded plans but rather by great financial stress among plans that have not been paying their pension bills. The simple fact is that a government is more likely to issue POBs if the pension plan represents a substantial obligation to the government, if the government has substantial debt outstanding, and if the government is short of cash.

Given this pattern and the risks involved, it's hard not to be skeptical of any entity proposing to issue a POB.