Pension Obligation Bonds Could Be Useful

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MarketWatch Blog by Alicia H. Munnell

Alicia H. Munnell is a columnist for ***MarketWatch*** and director of the Center for Retirement Research at Boston College.

But they are used only by the desperate.

Due to popular demand and the notion that, in the right hands, they might be useful, **we have updated our work on pension obligation bonds** (POBs). The early versions of these bonds offered a simple tax arbitrage. The plan sponsor would issue a bond at a tax-exempt (low) rate and invest in higher yielding taxable securities, such as U.S. Treasury bonds. This arbitrage option was eliminated in 1986 and one might have thought that POBs would disappear. But they re-emerged with the bull market of the 1990s, when governments concluded that they could borrow at taxable rates, put the money in a pension fund, which consisted mostly of equities, and make money.

This ability to borrow cheaply and invest in the stock market is one of the two major reasons for the appeal of POBs. The other is budget relief. State and local governments often face legal requirements to reduce underfunding, but when the economy is weak they are reluctant to raise taxes to make the required payments. Officials may see POBs as the "least bad alternative" among a variety of tough choices.

But the issuance of a POB also poses serious risks. The success of a POB depends on pension returns averaging more than the cost of financing the debt, which may not always turn out to be correct. Moreover, while the issuance of a POB does not change the total indebtedness of a plan sponsor, it does convert a somewhat flexible obligation that can be smoothed over time to inflexible debt with required annual payments.

The tone of our earlier work on POBs was quite negative. The entities using them were states and cities with severe pension problems, and, in the wake of the financial crisis, the average POB had lost 2.6 percent per year.

But I really like the notion of making a deal in the public pension world whereby the burden of the existing unfunded liability is taken off the plan in exchange for arrangements that ensure we never get into this fix again. The new arrangements would involve some commitment mechanism for the government to make its required contribution and some risk-sharing arrangement that spells out explicitly what happens if assumptions are not met.

A POB could be one way to deal with the unfunded liability. The issuance of such a bond would not be an act of desperation but a well-planned attempt to take advantage of the cyclical pattern of stocks and bonds. Ideally, all the paperwork would be completed and the offering could sit on a shelf until a recession produces a drop in rates and stock prices. Then the plan sponsor could borrow and invest opportunistically.

Of course, that is not what is going on now. In our updated analysis, which includes a greatly expanded number of POB issuers, we continued to find that financial pressures play a major role in the issuance of these securities. Governments are more likely to issue a POB if the plan represents a

substantial obligation to the government, they have substantial debt outstanding, and they are short of cash. POB activity has centered in ten states, with California, Illinois, and New Jersey – three states with extensive pension problems – in the lead. And Detroit issued POBs in 2005 and 2006 just as the market was approaching its peak.

Nevertheless, POBs in the right hands might be a useful tool. And while, immediately after the financial crisis, governments appeared to have lost money on their POBs, four years of economic recovery have improved their performance: as of today, these bonds have netted an annual real return of 1.5 percent per year.