Public Pension Funding Forum

Closing the Funding Gap Without Dismantling Public Pensions

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Sizeable unfunded pension liabilities continue to result in ongoing budget pressures, create downward pressure on credit ratings and remain a focal point for local and national media.
How Did We Get Here?

- Underfunding of ARC payments and lower than expected market returns have led to underfunded plans.

State & Local Pension Funded Ratios
FY 1990-2014

Source: Center for Retirement Research at Boston College, Public Plans Database
Consistent Fiscal Discipline is Paramount

• Plans must practice *consistent* fiscal discipline in order to maintain sustainable current and future funding levels. This includes:
  – Full funding of ARC payments, in both strong and weak budgetary periods
  – Investment policies and practices that will withstand financial downturns and capitalize on market strength
  – Plan benefits that are within the long-term financial means of the plans
“States that have the largest relative pension liabilities have at least one thing in common: a history of contributing less to their pension plans than the actuarially required contribution.”

- Moody’s Investors Service
Beginning in 2009, many public plans have instituted benefit reforms to improve sustainability.

- Increased employee contributions
- Increased age or service requirements for new hires
- Adjustments to post-retirement COLAs
- Reduced benefit multipliers
- Options of hybrid DB/DC plan to large groups of public employees

While helpful, these reforms will only attain their long-term objectives if coupled with disciplined employer contribution practices.
Long-term Sustainability and Strategy

• Decision-makers and stakeholders must move from discussions on short-term decisions and implications to a discussion on the long-term, perpetual nature of the benefits and funding needs.

• Sustainability through policy implementation:
  ✓ Have a pension funding policy that is based on an actuarially determined contribution
  ✓ Build funding discipline into the policy to ensure that promised benefits can be paid
  ✓ Maintain intergenerational equity so that the cost of employee benefits is paid by the generation of taxpayers who receive services
  ✓ Make employer cost a consistent percentage of its current and projected payroll
  ✓ Require clear reporting to show how and when pension plans will be fully funded
To be effective and sustainable, a pension funding strategy must be considered across three primary areas.

**Benefits**
- Benefit Structure
- Demographics
- Labor Negotiations

**Budgetary / Financial**
- Budget Flexibility
- Solution Options
- Credit Impact
- GASB Changes

**Investments**
- Return Assumptions / Projections
- Asset Allocation
- Liquidity Needs
Pension Obligation Bond Mechanics

- Issuers of Pension Obligation Bonds (“POBs”) issue debt in the taxable fixed rate markets and deposit the proceeds into their pension system.
- POBs are a risk-bearing arbitrage strategy between the cost of financing and the return on investment.
  - Investment rates that are greater than borrowing costs will achieve net savings to the pension obligation.
  - POB proceeds should be invested in asset classes that provide the best risk/return trade-off (i.e. Equities).
- **POBs replace a ‘soft liability’ with a ‘hard liability’**.
GFOA Best Practices for POBs

- The Government Finance Officers Association ("GFOA") advocates a thorough review and the use of caution before issuing Pension Obligation Bonds.

POBs as part of a larger strategy
- Pension Obligation Bonds, if used, should be utilized in conjunction with, and not in place of, sensible funding and investment policies.

Broader budgetary impacts must be considered
- Stakeholders should be aware that pension liabilities with debt service payments can limit budgetary flexibility, and may not eliminate unfunded liabilities in perpetuity.

Avoid extension of UAAL
- Pension Obligation Bond debt should not extend the unfunded actuarial accrued liability.

Creation of ‘hard liability’; impact on debt capacity
- Issuers should be mindful of the impacts on debt capacity, and the reporting implications of the hard debt liability.

Impact on multiple-employer systems
- Employers participating in multiple-employer systems should pay additional attention to the actuarial and cost implications of those plans.
There are numerous factors that must be evaluated and weighed when considering a POB that directly impacts the funding strategy.

- Conversion of a soft liability to a hard liability
- Issuance timing
- Issuer debt load and capacity
- Ratings impact
- Covenant risk mitigation strategies while debt is outstanding (to the extent legally enforceable)
  - Create separate trust structure within retirement system to facilitate a POB investment strategy that is different than system-wide asset allocation
  - Limit ability to provide benefit enhancements while POB debt is outstanding
  - Consider a rate stabilization fund from POB excess returns once funded ratio exceeds 90%
Pension Obligation Bond Timing

• The timing of when an issuer enters the market can significantly affect the performance of POBs.
• Stock prices fluctuate, and the risk of loss in the first recession after a POB sale must be evaluated carefully.

A ‘Pension Obligation Bond Window’ is the period of time an issuer can invest these bond proceeds in the stock market with a reduced probability of experiencing lower stock prices in the subsequent economic recession.
What is the Pension Obligation Bond Window?

- The period of time an issuer of benefits bonds can most reasonably expect to invest bond proceeds in the stock market without witnessing lower stock prices in the subsequent economic recession.
  
  - Measured from the bottom of the stock market (which typically corresponds to the trough of an economic business cycle) until the stock market ‘breakeven’ level with the subsequent stock market bottom.
  
  - Theoretically, the period in which the risk of subsequent cycle loss is < 50%.
  
  - Quantifiable only in hindsight.
  
  - No one can ever predict in real-time when there is a bottom.
It is important that POB issuers commit to taking a long-term view on the results of the strategy.

- History shows that over a long-term period (30-year), equities predominantly outperform POB funding costs; whereas shorter term views (5-year) provide more erratic performance results and greater risks.

**Distribution of Excess Returns* vs Fixed Borrowing Costs**

*Excess Returns is defined as S&P Forward Return minus AA Corporate bond yield.

Data source: Ibbotson Associates, Inc.
# The New Paradigm View of Benefit Bond Decisions

## Issuance Sizing
- Based on stage in business cycle
- Optimal recessionary sizing (80 to 85% for POBs; 65% for OPEB-OBs, preferably split in two issues)

## Financial Analysis
- Primary driver of issuance – equity market risk/reward characteristics based on stage in business cycle
- Dynamic reinvestment scenario analysis

## Investment Management
- Equity-only initially, no arbitrage in selling bonds to buy bonds
- Time-based migration to normal asset allocation

## Overfunding Risk Mitigation
- Restrictive covenants to preclude benefits “give-aways”
- Excess returns available to pay down debt
- Protective POB trusts

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Evaluating Funding Options

• All funding options, including benefit bonds or changes to annual funding practices, should be evaluated and compared across differing return and benefit payout scenarios.
• Decision-makers and constituents that are familiar with the range of potential outcomes and understanding of the impacts of different options will be well-positioned to make fiscally sound decisions.
Conclusion

- With proper discipline and planning, the funding gap can be closed without dismantling funds.
- This will take time, and requires leaders to adhere to a long-term view of the challenges and potential solutions.
- Solutions must not be viewed in isolation – must be a part of a long-term and holistic strategy.
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