# What You Should Consider About Benefit Bonds

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The issue of funding an increasing pension liability is always top of mind for many trustees and state officials. The fact is that for many, employee contribution rates continue to increase, discount rates are declining, and municipal contributions are under pressure due to many competing priorities. As a result, many plans are struggling with how to properly manage and continue providing benefits to their new and existing employees, while simultaneously trying to balance pressure from their respective municipalities to cut benefits and increase contribution rates.

Unfortunately, the investment outlook doesn't provide a respite from increasing liabilities in the near term, and global growth expectations continue to be ratcheted down. This means that cities and counties need to get creative, which in turn is leading to consideration or issuance of- pension obligation bonds (POBs).

To be clear, it is always better to fund retirement obligations with cash from the budget, however, there may be situations where the issuance of bonds, and specifically "benefit bonds," may make sense. In those cases, there likely has or will be significant preparation and evaluation in advance — potentially years in advance — of the actual issuance. The following are some important items that municipalities, managers, administrators, and other professionals associated with public employee retirement systems should understand and consider.

## First, Stop the Bleeding

Underfunded pension and Other Post-Employment Benefits (OPEB) plans do not typically materialize overnight; undoubtedly, there may be many factors that contribute to a poorly funded plan.

Plan reforms may be a viable solution, and could, at the extreme, involve closing the Defined Benefit (DB) pension or OPEB plan, but may also include less draconian fixes such as stronger funding policies or more risk-sharing with employees. In any case, if the root causes contributing to the declining funded status are not addressed, issuing bonds is a short-term action that may make the long-term solution far more expensive.

## Prepare to Issue When the Benefit Bonds Window is Open

These types of bonds are most appropriately issued during a certain "window," specifically when interest rates are low and there is a solid intermediate and long-term return outlook in the equity markets. In short, this allows the bonds to be issued relatively inexpensively with a relatively higher likelihood of positive arbitrage when the proceeds are invested in a diversified portfolio.

It is also worth mentioning that it is uncertain when and how long the benefits bonds window may be open. For this reason, is it unlikely that one will get the timing precisely correct. However, it is vital to issue and reinvest under the proper circumstances. Therefore, conversations with the authorizing body, preparing any legal or authorizing documents, and considering structures and sizes of the issuance in advance or anticipation of the window will help expedite the process. Remember that the time to use this strategy typically occurs when the markets are stressed, so professionals engaged in the administration and management of public retirement systems should prepare for benefits bonds issuance in advance, and at a time when emotion is not part of the equation. Remember, preparing for the event does not mean that one is required to issue the bonds.

## Structure the Issuance Appropriately

Debt structures can be issued on a “level debt service” basis, where the debt service can assume a shape similar to the current planned liabilities, or they may be structured to create budgetary flexibility or “savings” in targeted years. Depending on market dynamics, issuance size, and risk appetite, components can include both fixed- and variable-rate debt. Factors such as current and projected cost and budget dynamics must be taken into account holistically to optimize the structure and provide the greatest likelihood for achieving positive results.

A key consideration should be sizing the benefits bonds issuance to increase the solvency of the plan without creating a potential “overfunding” problem. For that reason, a plan that is significantly underfunded (which, in our view, is less than 80% funded at the recent June 1, 2021 equity market levels) should consider whether a multi-tranche approach to the debt issuance is cost-effective. This “dollar cost averaging” approach to debt issuance can help mitigate the negative effects of unintended/unforeseen consequences.

Another consideration in the bond structure is the amortization schedule. The Government Finance Officers Association (GFOA) best practice warned, “The POBs are frequently structured in a manner that defers the principal payments or extends repayment over a period longer than the actuarial amortization period, thereby increasing the sponsor’s overall costs.” As described above, the debt may be structured to provide budgetary savings; however, this benefit should be weighed against the downside of increasing total interest cost or unreasonably extending the length of time to pay off the liability. It would be common for an issuer, manager or trustee considering benefit bonds to follow a level percent of pay amortization, which by its structure defers principal payments, and/or to have a relatively long remaining amortization period — i.e., over 20 years — so that this will not be an issue in many cases. In short, this should be considered as part of the evaluation.

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## Protect the Taxpayers

Since retirement plan contributions and debt service payments are met by the taxpayer, governments should protect the public where legally possible. It is important to explore the ability to create policies and/or debt covenants that limit the ability of future governing bodies to increase benefits while the debt is outstanding.

## Ensure you have a Current Funding Policy

Employers and plan sponsors should discuss the funding policy with their financial advisors and actuaries. Even plans that have contribution requirements, amortization schedules, and other assumptions and components governed by state law should consider an updated funding policy tailored to their particular situation. One possibility is to set contributions at an enhanced level to address the underfunded status of the plan more aggressively than the statute.

A pension or OPEB funding policy that is written and formally adopted by the plan sponsor should also ensure that the normal cost of the benefit is funded annually, that the Actuarial Determined Contribution (ADC) is clear and annually funded, and that the debt proceeds can be deployed in the most advantageous manner, without risk of the intent being degraded by a lack of consistent and adequate contribution funding.

## Communicate your Strategies

The explanations relating to pension funding can be complicated and confusing to constituents. Whether it is the myriad of accounting and reporting standards, ratings agencies‘ views, or certain segments of the actuarial community advocating for an entirely different way to value pension liabilities, there is a tremendous amount of seemingly conflicting information available for public consumption. The mixed and conflicting messages serve to make life more difficult for plan stakeholders.

Regardless of the time period, markets are unpredictable. As a result, even a well-timed debt issuance may not appear successful during the entire term of the outstanding debt. With the potential for negative year-to-year financial implications, the various assumptions, any risk-mitigating features included in the issuance, and various scenarios should be discussed with the authorizing governing body and communicated to the public. There should be a clear outline of the strategy to manage/contain benefits growth, create funding certainty, and alleviate risks along with discussions of any other exogenous variables that could impact the strategy negatively in the short- or long-term.

For more information about this report and its contents, please reach out to your PFM Asset Management representative.

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