Pension Obligation Bond Financing of the Unfunded Accrued Actuarial Liabilities at the Municipality of Anchorage

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Introduction

Governmental units across the country are faced with the ever increasing unfunded liability in their retirement systems. This paper will examine the status of the liabilities in the Public Employees’ Retirement System and the Teachers’ Retirement System in Alaska and demonstrate the effects that unfunded liabilities are having on the Municipality of Anchorage.

First, we will provide background information on the status of Alaska’s retirement system and define unfunded accrued actuarial liabilities (UAAL) and pension obligation bonds (POBs). Next, we will examine pending legislation in the Alaska State Legislature relating to retirement system bonding. The discussion will then progress to the use of POBs to finance UAAL at the Municipality of Anchorage. We will then provide information on how this issue is affecting other areas of the country, and finally, we will provide recommendations to the Municipality of Anchorage on the use of POBs to finance UAAL.

Alaska’s Retirement System

The retirement systems in Alaska are the Public Employees’ Retirement System (PERS) and the Teachers’ Retirement System (TRS) as well as the Judicial Retirement System and the National Guard/Naval Militia Retirement System. For the purposes of this paper, we will examine only the PERS and TRS systems.

Both PERS and TRS are considered defined benefit plans. In a defined benefit plan the benefit paid to an employee is based upon a formula set in law and is not determined by the account balance. The benefits paid to the employee are based on a formula that calculates the length of service, salary, age, etc. and is paid for the life of the member, and adjusted payments are made for any survivor. The benefit is generally adjusted for cost of living increases and post
retirement pension adjustments. The benefit includes a health care provision, with a low-cost fee paid by the member. This benefit is not affected by plan funding methods or the funding levels of the plan, market gains, losses and expenses (Staack, 2003).

Both PERS and TRS have undergone various permutations since their inceptions (1961 and 1955 respectfully) but they have always been classified as defined benefit plans. Both PERS and TRS were scheduled to implement a defined contribution plan beginning on July 1, 2006 but as of this writing there is legislation pending in the Alaska State Legislature to postpone the plan for one year until the System changes receive final approval from the Internal Revenue Service (Anchorage Daily News, April 26, 2006). It is assumed that the current Systems would continue until the defined contribution plans are officially in place.

The Alaska Retirement Management Board (ARMB) oversees both PERS and TRS. The Board consists of nine trustees and is staffed by the Department of Revenue, Treasury Division. The Governor of Alaska, Frank H. Murkowski, appoints all of the trustees. The composition of the Board is:

- Commissioner of Revenue
- Commissioner of Administration
- 1 finance officer of a participating political subdivision
- 2 members of the general public
- 2 members selected from a list of four nominees submitted by the PERS bargaining units
- 2 members selected from a list of four nominees submitted by the TRS bargaining units.

The Board is tasked with “implementing changes in the oversight and management of the state’s existing defined benefit plans for PERS and TRS”…and also managing the “assets and
This includes making decisions regarding contribution rates, asset allocation and liability assessment for the retirement systems (Gov. Makes Appointments, 2005).

“The board is required to appoint an Investment Advisory Council (IAC) composed of at least three and not more than five members who possess experience and expertise in financial investments and management of investment portfolios. ARMB also contracts with an external consulting firm for assistance with asset allocation and strategy, performance measurement and general consulting purposes” (ARMB, 2006).

As of June 30, 2004 (the last year for which data is available), the Public Employees’ Retirement System had 161 participating employers, including the Municipality of Anchorage, the Anchorage School District and the Anchorage Parking Authority. There are 33,612 active members enrolled in the System, 19,572 retirees and their beneficiaries and 5,965 vested members who have terminated employment but are not yet eligible for benefits. Each police/fire member is required to contribute 7.5% of their compensation; all other members contribute 6.75%. Those members of PERS who elect to have their service calculated under TRS contribute 9.6%

As of June 30, 2004, the Teachers’ Retirement System had 58 participating employers, including the Anchorage School District. TRS has 9,688 active members enrolled in the system, 8,707 retirees and their beneficiaries and 724 vested members who have terminated employment but are not yet eligible for benefits. Each member is required to contribute 8.65% of their base salaries, which is deducted before federal income taxes are withheld.

The remaining amount to fund the systems is then provided by the participating employers, less investment returns. As mentioned earlier, the contribution rates for the
employers are set by the Alaska Retirement Management Board, which bases its decision at
where to set the rate on an annual actuarial valuation of PERS and TRS.

**Unfunded Accrued Actuarial Liability**

The annual actuarial valuation is calculated using what is known at the Projected Unit
Credit (PUC) method. The objective of this method is to fund each participant’s benefits under
the plan as they accrue. The components of the method are:

- **Normal Cost:** The present value of those benefits which are expected to be credited with
  respect to service during the year beginning on the valuation date.

- **Actuarial Liability (Accrued Liability):** Calculated at the valuation date as the present
  value of benefits credited with respect to service to that date.

- **Unfunded Actuarial Liability (UAL):** At the valuation date, is the excess of the accrued
  liability over the assets of the plan. The annual payment to be made over a stipulated
  number of years to amortize the unfunded liability is the past service cost (Mercer, 2005).

This valuation is an estimate of total liabilities at a given point in time and is based on over 20
assumptions; the major ones being:

- **Investment Return**

- **Health Care Cost Trends**

- **Mortality – the expected “life expectancy” of a beneficiary**

- **Past Service Amortization**

- **Smoothing Method** (to level out the highs and lows of investment earnings) (Staack,
  2003).
The ARMB is obligated to amortize the UAL over a period of time established in advance at the interest rate established by the ARMB, currently 8.25%. This interest rate is usually the same as the actuary’s assumed rate of investment return on the pension fund assets.

Taking into account all the assumptions, the UAAL for both PERS and TRS has continued to grow since 2001. As of June 30, 2004 the UAAL for PERS was $3.41 billion and $2.28 billion for TRS. The Anchorage portion of the entire UAAL for PERS was $463 million and $731 for TRS. The graphs below show the decreasing funding ratios since 2000, when both PERS and TRS had surpluses.
Some of the reasons underlying the increase in the UAAL are both the poor performance of the investments holding the retirement systems as well as rapidly increasing health care costs.

With regard to PERS, another reason for the increasing UAAL is a limitation put in place regarding the maximum amount an employer’s contribution rate can be changed (raised or lowered) per year. That maximum is set at 5%. Therefore, even if the actuary recommended an increase in the employer contribution level beyond the 5% in order to meet those future obligations and fully fund PERS and TRS, the maximum contribution the participating employer would make in that year is 5%. (Staack, 2003).

Given this ever-increasing UAAL, the state of Alaska and the Municipality of Anchorage are investigating different alternatives to lessen the shortfall. One of the options currently under consideration is the use of pension obligation bonds.
Pension Obligation Bonds

Due to investment losses, benefit enhancements, and increases in healthcare costs many public pension funds have found themselves significantly under-funded. This under-funding results in a UAAL. Repayment of the UAAL is amortized over a fixed period with assigned interest rates, currently at 8.25%. States are looking for alternative ways to pay off their UAAL at significantly lower interest rates. One tool that many governments have turned to is the pension obligation bond (POB). Though the potential for great savings is appealing, this goal may not be easy to come by. The success of POBs is heavily dependant on the market and there is no guarantee that savings will be generated long term. Federal tax regulations dictate that POBs are usually issued at taxable rates, making it more difficult to achieve the interest rate savings objective. Additionally, governments, who are already facing budgetary stress, may find it difficult to receive healthy credit ratings on POBs, which, in turn, makes it harder to receive a low interest rate on the issue.

By issuing a pension obligation bond, the issuer is essentially selling its debt in the bond market. Most states in good economic standing are able to issue bonds at relatively low interest rates, which are currently around 6%. The money from selling the bonds goes directly into the pension fund to pay a portion or all of the pension’s unfunded liability. Originally, states issued bonds to cover 100% of their unfunded liability, but because the UAAL is subject to change it is much more common to issue bonds to cover only a portion of it at a time. Once the bond funds are reinvested in the pension fund, the proceeds from the pension fund’s investments are used to pay back the total cost of the bond. Basically, the state has replaced its pension debt at 8.25% with a bond debt of 6%. This has the potential to create substantial savings in pension costs for the issuer.
POB Risks

There are risks involved with this transaction, however, because the final amount of interest savings cannot be determined with certainty. First, factors on which the UAAL is based are constantly changing. These factors include, but are not limited to: mortality rate, investment return, and increasing health care costs. The interest rate assigned by ARMB on the UAAL may change from time to time during the life of the bond issue. If the assigned interest rate drops below the bond interest rate, the UAAL will skyrocket and the state may find it to be in a worse situation than if it had not issued the bonds. So far this has not occurred, even though the assigned interest rate in some cases has dropped by more than one percentage point since the mid-1990s (Davis, 2003). Furthermore, this possibility considered to be unlikely because the assigned interest rate is based on an assumed investment rate of return which reflects investments with a higher risk profile and, therefore, higher projected return than the POBs.

On the other hand, it is possible that the assigned interest rate could rise above 8.25%. This would generate more savings for the issuer and an over-funded pension system. This case is likely to result in increased political pressure to re-distribute the excess earnings to beneficiaries in the form of increased benefits. If the legislature succumbs to this pressure, as many have, they could be facing serious trouble if the market begins to decline, as it did from 2000 to 2003, and the increase in benefits becomes too difficult to sustain over an extended period of time. This will cause pension funding ratios to drop again, resulting in another unfunded liability. If pension funding ratios become too low, employers may have no other choice but to go back to the market and issue POBs for another time.
POBs at Taxable Rates

The act of issuing bonds for the sole purpose of investing the proceeds in pension fund assets is a classic example of risk arbitrage. Arbitrage is defined as “the simultaneous purchase and sale of assets that are potentially but not necessarily equivalent” (Burnham, 2003). However, risk arbitrage is not the typical municipal bond arbitrage that stems from borrowing at tax-exempt rates and then investing at taxable rates. Rather it is a form of arbitrage derived from borrowing against the credit of the state or local government and participating through the pension fund in a portfolio of investments that is designed to produce a higher yield and manage the higher risk through diversification (Davis, 2003). Because pension bonds are used for financial risk arbitrage, federal law dictates that they are issued at taxable rates. This is due to provisions in the Tax Reform Act of 1986. Governments usually issue taxable bonds at higher interest rates than they would for tax-exempt bonds, making it that much harder to achieve the desired interest rate savings on the debt. However, recent taxable rates have been at historic lows, so issuers are more willing to take the risk that the cost of paying off bonded debt will still be substantially lower than the original cost of paying off the UAAL.

POB Credit Ratings

Credit ratings also affect interest savings. A POB’s credit rating is a direct assessment of the risk associated with its repayment. As the risk on the bond increases, lenders demand a higher return for their loans. Since the objective to issuing POBs is interest rate savings, issuers want to issue their bonds at the lowest possible rate. Therefore, risk is important to both borrowers and lenders and, in bond markets, risk is assessed by three different commercial rating firms: Moody, Standard & Poor, and Fitch.
These companies generally rate on an A, B, C, scale—the highest rating being AAA, and the lowest, generally being a D. The commercial rating firms take into account a multitude of factors when assigning a credit rating. One of these factors is the bond issuer’s debt position. A high debt burden and high debt service requirements in relation to government resources raise questions about the credit risk of a bond (Mikesell, 2003). But, because POBs simply replace existing pension obligations, they are not generally viewed as adding to the debt burden of the issuer. To quote the rating agencies:

“Moody’s believes the issuance of pension obligation bonds (POBs) is one effective way of addressing an unfunded liability, their issuance is not by itself a credit weakness. However, the planning and analysis conducted by a local government as part of the decision to grant expanded benefits, the government’s plan for funding any unfunded pension liability, and its ability and willingness to budget appropriately for any attendant higher costs, are reflective of the quality of the government’s overall financial management. These factors, therefore, will be considered in our assessment of a government’s general credit quality.”

“Standard & Poor’s factors the effects of a pension obligation bond strategy into the long-term rating of the sponsor. Standard and Poor’s has viewed POBs as a strategy for savings on carrying charges as long as the transaction was structured conservatively and the assumptions were reasonable and attainable. This requires a clear financing plan including reasonable assumptions and manageable leverage. Prudent expectations for investment returns and cautious use of resultant savings help insure a POB’s success. Another positive factor for a POB is, of course, to be fortunate enough to sell the bonds
in a low interest rate environment, thereby increasing the spread between interest costs and investment return expectations and lowering the risk of underperformance.”

“Fitch believes that POBs, if used moderately and in conjunction with a prudent approach to investing the proceeds and other pension assets, can be a useful tool in asset-liability management. However, a failure to follow balanced and prudent investment practices with respect to POB proceeds could expose the sponsor to market losses. Because a sponsor’s unfunded pension liability is already factored into the rating, the issuance of POBs simply moves the obligation from one part of the balance sheet to another. However, Fitch notes that POBs create a true debt, one which must be paid on time and in full, rather than a softer pension liability that can be deferred or rescheduled from time to time during periods of fiscal stress. Consequently, POBs can have a significant effect on financial flexibility over time” (Davis, 2003).

It is important to emphasize that a healthy or unhealthy credit rating on the POB is a strong determinant of the interest rate attached to it. Because these ratings are directly related to the financial situation of the issuer, it is important to address the effect that issuing POBs can have on an issuer’s financial status.

Borrowing for any purpose increases debt, and incurring debt to pay unfunded liabilities is no different. Even though the issuer is simply substituting one type of debt for the other (the POB liability for the UAAL liability), there is a difference between the two. In most cases, bond debt service is a “harder” obligation than the “softer” contribution payments used to pay the UAAL. Bond debt service must be paid in full and on time or the issue falls into default, which
can have severe consequences on the issuer’s credit. Pension contribution payments, on the other hand, have more flexibility and may be temporarily deferred or reduced without serious repercussions. POBs replace this potentially flexible pension obligation with a more absolute bond obligation. Therefore, it is essential that issuers be financially strong enough to be able to commit to the POB payment terms, even if the expected interest rate savings do not occur. In the event that the pension plan experiences large investment losses or enhanced benefit costs while the POB is outstanding, it is possible that the issuer would have to cover not only the debt service payments on the bond issue, but the increased pension contributions as well. A financially weak issuer may not be capable of handling such situations.

**Legal Factors of Issuing POBs**

There are also legal considerations for issuers to take into account before issuing POBs. Governments should be sure that they are legally authorized to issue these bonds and that other legal or statutory requirements governing the pension fund are not violated. Granting a legal authority to issue and manage POB debt may be the greatest obstacle in many states. Currently, the Municipality of Anchorage has submitted legislation to appoint the Alaska Municipal Bond Bank Authority to handle such matters. This legislation will be highlighted later in this document, however, under House Bill 278:

The Alaska Municipal Bond Authority would be authorized to consider issuing POBs at the request of the state or a municipal governmental employer. HB 278 expands the authority of the Alaska Municipal Bond Authority to support the state or a municipality that wishes to include POBs in their strategy to reduce the cost of meeting unfunded pension liabilities. This bill does not authorize any debt instruments to be issued. The
state or a municipality would need to take a separate action to utilize this new ability of the Municipal Bond Bank Authority (Lucky, 2005).

An alternative to the Alaska Municipal Bond Bank Authority would be to allow individual employers to issue and manage their own POBs. However, these employers may have low bond ratings or lack familiarity among the investors in the market, which would result in higher interest rates on the bonds. The Municipal Bond Bank received an A rating from both Moody’s and Standard and Poor, which enables it to borrow money at low rates.

As many potential benefits exist from issuing pension obligation bonds, there are also equal risks. POBs have proven to be successful financial instruments intended to relieve the issuer of some of the annual pension contributions by using the proceeds to pay some or all of the pension plan’s unfunded accrued liability. However, in order to achieve the expected budgetary relief, the issuer must invest wisely to insure that bond proceeds return a higher rate than the total cost of borrowing. Unexpected market fluctuations, increased pension benefits, and changes in employee demographics can all affect the UAAL. If these changes take place while the bond is outstanding, issuers may face higher than expected costs. It is important that the issuer be financially secure enough to handle these potential expenses.

Structuring the bond to achieve the lowest possible interest rate is also important for interest savings. POBs are taxable and therefore, issued at higher rates than tax-exempt bonds. This is due to federal mandate and at no fault to the issuer. However, insuring the bond receives a healthy credit rating and being fiscally responsible with payments will all contribute to lower interest rates on the issue. Governments should also be aware of any constitutional restrictions that may limit their ability to issue POBs.
House Bill 278: Retirement System Bonds

The rapid growth in unfunded liabilities for public pension funds over the last few years, driven by investment losses, benefit enhancements, and greater longevity of pension plan beneficiaries has increased the number of POBs in the market. In response to the multibillion-dollar shortfall in Alaska's state-administered retirement funds, Representative Mike Hawker has introduced House Bill 278 (HB 278) Retirement System Bonds. HB 278 provides governmental employers the opportunity to use POBs to help reduce the cost of satisfying UAALs. As explained earlier, a POB is essentially a legal arbitrage transaction where money is borrowed at a lower rate of interest than the money earns when invested by the retirement system.

HB 278 clarifies the ability of municipal entities to include POBs in their strategy to reduce the cost of meeting unfunded pension liabilities and expands the authority of the Alaska Municipal Bond Bank Authority to support governmental employers who desire assistance in engaging in such transactions.

POBs in Anchorage

The UAAL for the Municipality of Anchorage is $463 million for PERS and $731 million for TRS as of June 30, 2004. By 2011, employer contributions are projected to increase to 32% of payroll for PERS and 50% of payroll for TRS. One option to alleviate this burden on annual appropriations is to consider issuance of pension obligation bonds (POBs).

Authority to Issue POBs

The first question is whether the Municipality has the authority to issue POBs. Article IX, section 9 of the Alaska Constitution provides, in part, that no “debt” may be incurred by any
political subdivision of the state except for “capital improvements” approved by a majority of the eligible voters. These terms have been construed by the Alaska Supreme Court over the years; suffice it to say at this point that POBs would constitute “debt” as defined by the Alaska Constitution, but use of that debt to satisfy the Municipality’s UAALs to PERS and TRS would not constitute a “capital improvement.” There is an exception to these restrictions on capital improvements and voter approval for revenue bonds, as defined in Article IX, section 11 of the Alaska Constitution:

“The restrictions on contracting debt do not apply to debt incurred through the issuance of revenue bonds by a public enterprise or public corporation of the State or a political subdivision, when the only security is the revenues of the enterprise or corporation.”

The question then becomes whether POBs may be issued as “revenue bonds” by a public enterprise or public corporation. If so, the Municipality would not be constrained by the “capital improvement” requirement, nor would POBs require voter approval. The difficulty with this approach, however, is that the “only security” for repayment of the revenue bonds must be “the revenues of the enterprise or corporation.” There is no available source of revenues for any such enterprise or corporation formed to satisfy the Municipality’s UAALs; such enterprise or corporation would not own any capital improvement capable of producing such revenues. While the Municipality has taxes and other sources of revenue, the Alaska Constitution requires that the “only security” for repayment of the revenue bonds is the revenue of the public enterprise or public corporation.
Previously, it was stated that POBs would constitute “debt” as defined by the Constitution because POBs would require a long-term obligation backed by the full faith and credit of the Municipality to repay borrowed money. The next question is whether the POBs may be re-structured so as not to constitute “debt.”

If POBs determine that repayment is subject to annual appropriations by the Anchorage Assembly, then there is no longer any long-term obligation to repay them; repayment would, be at the annual discretion of the Anchorage Assembly. According to the Alaska Supreme Court, such obligation would no longer constitute “debt” as the term is used in Article IX, section 8 of the Alaska Constitution:

“When taken together, this court finds that the foregoing Alaska cases and the cases cited by the Alaska Supreme Court define constitutional “debt” as a term of art used to describe an “obligation” involving borrowed money where “there is a promise to pay sums . . . in the future whether funds are available or not.” Where a [loan] agreement does not require a future legislature to appropriate funds, the agreement is not a long-term binding obligation to repay borrowed money pursuant to article IX, section 8, and is not “debt” as defined by the Alaska Supreme Court.”

If a POB is not “debt” in the constitutional sense, then it need not be issued for “capital improvements” and it does not require voter approval. POBs could be issued by the Municipality, a home rule municipality, under its existing power and authority to incur debt (Alaska Statutes 29.04.010 and 29.10.200), subject only to approval by the Anchorage Assembly (Anchorage Municipal Charter section 10.02(2)).
Issuance of POBs at Lowest Interest Rates

A POB need not take any particular form. It may be in the form of traditional long-term bonds (subject to the aforementioned non-appropriation provisions), or simply in the form of a promissory note or other evidence of indebtedness. It could, for example, take the form of a lease arrangement coupled with certificates of participation (Hildreth and Zorn at pages 139-41).

The Municipality could enter the taxable bond market to issue POBs. The rate of interest payable on POBs would be set by the market place, subject to a variety of factors, the most important being that POBs will not be backed by a pledge of the full faith and credit of the Municipality (so as to avoid the Alaska constitutional restriction of “debt”). Without this pledge of full faith and credit, POBs will be perceived by the marketplace as riskier, thereby increasing the interest rates of POBs.

There are a number of mitigating rates, called “credit enhancements,” available to the Municipality to reduce those costs. POBs could be backed by a pledge of some limited revenue stream, or secured by a mortgage on Municipal real property or by another form of security other than a pledge of the Municipality’s taxing power. It may be non-callable. These enhancements should be evaluated favorably by any of the rating agencies in rating POBs and should be reflected in lower interest rates required by investors.

Further, the Municipality could purchase bond insurance, in essence pledging the assets and credit rating of the insurer for repayment of the Municipality’s POBs, but such insurance will certainly increase the cost of issuing POBs, thereby increasing the risk of pursuing POBs as a strategy for reducing UAALs.
Recall that the essential concept of POBs is to substitute a UAAL obligation payable over 25 years at 8¼% with a POB payable approximately over the same 25-year period at a lower market rate of interest. The concept in essence fails if the rate of return on investment of the proceeds of the POB does not exceed the interest rate on the POBs: The investment rate of return must exceed the interest rate payable on the POBs. The higher the interest rate payable on POBs, the higher the risk that the investment returns will not exceed the POBs’ interest rate.

An alternative to issuing POBs in the marketplace is to issue POBs to the Alaska Municipal Bond Bank Authority. The Authority would then issue its own POBs or other bonds on either the taxable or the tax-exempt markets. This would be possible, provided that HB 278, presently pending in the Alaska Legislature and discussed earlier in this paper, or comparable legislation, is enacted.

The Municipal Bond Bank would then be able to issue bonds by pooling the debt obligations or lease arrangements with those of a multitude of governmental employers and enter the market with a larger bond issue, usually at a lower cost than if each of the governmental employers entered the market separately. Aside from the pooled risk and economies of scale associated with state-wide bond issues, there are at least a couple additional “credit enhancements” afforded bonds issued by the Municipal Bond Bank which should reduce the cost of issuing POBs.

First, the bonds are “backed” by the moral obligation of the State (Alaska Public Debt 2005-2006 at page 3). By January 30 of each year, the chairman of the Municipal Bond Bank must certify to the Alaska Legislature the amount necessary to restore the Municipal Bond Bank
reserve fund to “the amount required to be on deposit,” as determined by the Municipal Bond Bank. The Legislature may, but is not legally required, appropriate funds in that amount.

Second, the Municipal Bond Bank has authority to divert, or intercept funds otherwise payable by any state agency to a municipality and apply those funds directly to the amounts owed by that municipality to the Municipal Bond Bank, or subsidiary thereof.

Third, the State could guarantee the debt of the Municipal Bond Bank. This would be a departure from current practice, but not without current authority.

**Investment of POB Proceeds**

With the Municipality assessing all its options for issuing POBs at the lowest rates, utilizing whatever “credit enhancements” it deems prudent, the question then arises as to the most prudent investment of the net proceeds of the POBs. Again, the returns earned on these investments are critical to the success of any POB program.

It is contemplated that the proceeds of any POBs issued by the Municipal Bond Bank would be used to prepay in lump sum all or a portion of the Municipality’s UAAL(s) to either PERS or TRS (or both), assuming enactment of HB 278 or similar legislation. Those proceeds would be invested under the management of the newly formed ARMB, responsible for the management and investment of the assets of PERS and TRS and similar fund (Alaska Statutes 37.10.210 and .220).

The investment returns realized by the ARMB’s predecessor, the Alaska State Pension Investment Board, certainly are not conducive to issuing POBs: the PERS 5-year, 3-year, and 1-
year investment returns for year ended December 31, 2004, are 3.32 %, 7.42 %, and 10.79 %, respectively (TRS’ investment returns are comparable). Not only do these returns not meet the actuarial earnings rate of 8¼ % set by the ARMB, thereby resulting in more UAALs, but at least the 5-year return is not likely to exceed the interest rate on the POBs, thereby creating what will be called a “disaster.” Concededly, 2001, 2002, and even 2003 were recessionary years, and it was difficult to realize historically higher returns, however over a 25-year amortization period, such market cycles need to be anticipated and incorporated into conservative assumptions of future investment returns.

Caution must be exercised not to prepay too much to either PERS or TRS. If HB 278 passes, once prepaid, such proceeds may not be refunded to the Municipality for any purpose; they must be used solely to offset contributions. On or about April 14, 2006, the ARMB submitted three proposals for addressing the unfunded liabilities of PERS and TRS. These proposals “address employer concerns with escalating contribution rates and the growing actuarial shortfall of the retirement systems” (ARMB Final Report to the Legislature, 2006). Each of the three proposals involve legislative appropriations to fund contributions to PERS and TRS in varying amounts: 1) to cover the full UAALs of governmental employers, including incentives to prepay UAALs; 2) to pay one-half the increased past service contribution for fiscal year 2007 ($18.6 million); and 3) to fund the fiscal year 2007 difference between the actuarially required past service contributions to PERS and TRS and the projected actual contributions to PERS and TRS ($208.5 million).

Even though it is late in the legislative session, it is possible one or more of these proposals or a comparable proposal will pass. The ARMB is continuing to assess the fiscal, practical and legal issues regarding issuance of POBs by or for the benefit of public employers.
In other words, the Municipality’s UAALs may be substantially decreased by legislative action to address the unfunded liabilities facing governmental employers across the state; with such possibility, the Municipality doesn’t want to be in effect penalized by prepaying too much too early to PERS and/or TRS.

An alternative to prepayment of POB proceeds to PERS and TRS for investment by the ARMB would be to deposit those proceeds in a separate prefunding account established by the Municipality for the specific purpose of managing and investing those proceeds. There is precedent for such account with the Municipal Prefunding Investment Program established in 1995 to prefund the Municipality’s obligation to make contributions to the Police and Fire Retiree Medical Funding Program (Anchorage Municipal Code chapter 3.88). It was considered prudent in 1995 to prefund, over 20 years, the Municipality’s obligation to make contributions to the Funding Program projected to extend over 70 years.

The Investment Program is managed by a five-member Investment Board appointed by the Mayor, subject to Anchorage Assembly confirmation. According to Municipal Code, the Investment Board has the authority to establish its own investment policies restricted only by the prudent investor standard. Its 5-year, 3-year, and 1-year investment returns for year ended December 31, 2004, are 3.3 %. 8.0 %, and 11.1 %, respectively, substantially the same as the investment returns realized by PERS (and TRS).

A similar investment program could be established by ordinance approved by the Anchorage Assembly, funded with the proceeds of POBs, and managed under investment policies established by the Municipality. The investment objective of the program would be to equal or exceed the 8¼ % (or other actuarial earnings rate) set by the ARMB. Surplus funds
accumulated in the investment program could be refunded to the Municipality, after repayment of POBs, to be used for other municipal purposes.

**Case Examples**

There are numerous states and municipalities throughout the nation that are facing the problem of unfunded pension liabilities. Increases in the life spans of beneficiaries and medical costs have forced many governments to consider issuing POBs. Cities such as Pittsburgh, Los Angeles, San Francisco, Worcester, MA and Portland, OR and states like Illinois, Massachusetts, Kansas, West Virginia, California, Texas and others have all considered or issued POBs (Young and Murphy, 2004). In fact, a study by Wilshire Associates found that 84% of the pension systems they examined were under funded. This leaves cities and states with a difficult choice: increasing taxes, or issuing POBs (Bartlett and Steele, 2005).

While there are numerous circumstances that can affect how efficiently and quickly a city or state can pay off its bonds, or rapidly incur massive debt, there seem to be several warning signs about how well bond issuers will do, and what the impact to taxpayers will be. Investment proceeds reinvestment into the pension bond, financial solubility and market status seem to be prime indicators. The following are examples of success and disaster stories from various states and cities, and a simple analysis of factors that may contribute to an issuer’s ability to retire a bond.

1. **Oregon: The Perfect Storm:** Similar to Alaska, the state of Oregon’s Public Employees Retirement System (OPERS) was fully funded throughout most of the 1990s and the system seemed able to support an increase in benefits. And like many other states, its recent unfunded liabilities seem to be linked to the economic depression at the beginning of the
century. At that time, the state fell short of its pension obligations by more the $9.7 billion before bottoming out at almost $15 billion in unfunded liabilities.

Facing this fiscal crisis, the state attempted several fixes before turning to POBs. It first adjusted the OPERS system to curtail benefits increases and stabilize the program. Like Alaska, it also created a new class of public employees, hired after a certain date, that were subject to new terms and contribution requirements to receive retirement benefits. These changes helped mitigate the Oregon’s unfunded liabilities but to further reduce projected shortfalls, employer contributions increased dramatically by more then 8%. The state also issued about $2 billion in POBs in 2003 to cover the remaining liability (Young and Prunty, 2005).

The Beaver state is expected to retire these bonds on time and recently received a fair economic grade from Wall Street as a sound state to invest. The state also has a sound economic base with a net population increase per year and if so forced, could increase taxes to cover its bond and pension debts. Oregon’s success seems to be due to its no-reliance on the market: the state took several steps to reduce the amount of bonding it would require to cover its pension funds as much as possible thereby reducing the chance of further economic burdens (Young and Prunty, 2005). These combined factors, along with a strengthening national economy, may have created a favorable situation for issuing POBs as a means of fully funding pensions and saving tax payer dollars. Other states have not been as fortunate and in fact are deeper in debt since issuing their POBs, though additional factors certainly apply.

2. **Illinois: Sharing the Market’s Fate**: The state of Illinois is currently facing a $39 billion unfunded liability and conditions are not expected to improve (AP, 4/14/06). In order to make payments on bonds it issued for more then $10 billion in 1995, the state is facing massive budget cuts or a dramatic tax increase. The Illinois budget originally began to
fall short of anticipated bond pay dates when the market recessed in 2001 and state failed to meet expected returns. In order to comply with a state law that requires pension benefits be provided at specified contracted level, Illinois purchased another $10 billion POB in 2003 to continue providing retirement benefits at the established rate.

Illinois was not always facing such a dramatic financial burden. After issuing its original bonds in 1995, the state enjoyed several years of higher then expected market returns and was on its way to a fully funded pension system. Budget outlooks suggested that it might even be possible to retire the bond a few years earlier then expected. Unfortunately for Illinois, the economic recession of 2000-2001 dramatically reduced their investment returns, and like numerous other cities and states, is now even further mired in debt. The state now has the dubious distinction of holding the largest POB and unfunded liability debt in the nation (Young and Murphy, 2004).

Illinois is a state that appeared to purchase POBs under favorable conditions yet due to market forces, is now left in even deeper debt. Unlike Oregon, this state does not have the option to readjust its pension system but could (and will likely have to) burden taxpayers with the public employee’s debt. The Prairie State continues to adhere to a fairly rigorous payment schedule and only in recent years has the state been unable to make on-time payments, resulting in an extension of the payment time line. It simply seems that Illinois gambled on POBs and is continuing to lose the wager. Yet state law allowed few other options.

3. San Diego: Deep in the Hole: The city of San Diego, CA faced a pension fund liability in the early 1990’s and after considerable debate among the county administrators, opted to issue pension obligation bonds to cover the liability. The city issued the bonds in 1994 and enjoyed excessive returns on its proceeds during the economic and dot-com boom, culminating
in a $320 million surplus at the end of the century. However, with the fall of the stock market in
the 2001, the city was no longer able to generate returns on its POB investments and by 2002,
was facing a deficit of 1.25 billion. In spite of this, the San Diego County Employees'
Retirement Association (SDCERA) decided that the system could handle increased benefits
without undue burden on the county’s taxpayers if the amortization period was extended from
the standard 5 year period to 8 years. To further reduce the initial cost burden on taxpayers,
SDCERA then pushed back the amortization period to 15 years on a rolling payment schedule,
before settling on a 20 year fixed rate (Lewis, 2005).

To pay off outstanding pension liabilities, the San Diego County Administration next
took out a loan for more then $737 million, the remainder of which was reinvested in the pension
system. By 2003, the county still could not keep pace with its pension benefits and was again
unfunded for nearly 25% of its projected liability (Lewis, 2005). Again the county borrowed
money to cover the liability, but at its current rate, the county has a debt of more then $1.27
billion, which is not expected to be paid off until at least 2022 (Bartlett and Steele, 2005).

San Diego seems to be a classic case of a pension system that borrowed during favorable
market conditions, only to fall short of an 8.25% return during leaner economic years. The city
was forced to borrow more money to cover its liabilities, additionally accruing bond debt. While
market factors may have been out of the city’s control, the 2002 retiree benefits increase was
perhaps what has impacted the city’s current debt the most. By increasing benefits instead of
paying off bond debt, the city not only continued to accrue bond debt interest, but also increased
its pension liability, which would prove to be cumbersome in later years when the market failed
to return greater then expected rates.

4. **Pittsburgh: Poor Bonding Prospects**: In 1984, the state of
Pennsylvania required through Act 205 that all municipalities amortize all POB plans over a 40-year period. In compliance with this act, the city of Pittsburgh adopted a gradually increasing payment plan to pay off bonds covering more then $519 million in unfunded liability (Bartlett and Steele, 2005). Like other northern urban centers, Pittsburgh was facing a population decline and a dwindling tax base, compounding its economic stress. The bonds it issued in 1998 failed to make pace with expected returns and in order to cover new unfunded liabilities, the city then purchased more bonds in an effort to fully fund its retirement system (Terry, 2006). The city also switched to a static payment plan to offset skyrocketing employer contribution costs mandated by the increasing payment plan. The city’s financial woes were not yet over, as reallocations from the municipal budget were used to keep the pension system afloat during the economic recession of the early century. When these sources dried up, Pittsburgh faced yet another unfunded liability. More POBs were issued to cover the debt, at 6.5% for a $256 million bond. Taxpayers in the steel city will be paying off these debts well into the next generation (Burnham, 2003).

Pittsburgh’s actions perhaps provide a guide for when it is unwise for a city to purchase POBs. Already in financial trouble, the city’s unfunded liability compounded its problems and forced it to extend its payment schedule, leaving Pittsburgh with more debt during recession periods of insufficient investment returns. The city was relying heavily on sufficient market returns to cover its investments, a risk for any bond issuer, but one substantially more dangerous for a city with inherent financial woes. Additional pressures from strong teachers and public employees unions to maintain if not increase benefits may have prevented legislators from restructuring the city’s pension system to reduce the liability, as was done in Oregon, and so increased the bonding amount (Burnham, 2003).
5. West Virginia: Learning from Others: The state of West Virginia, in an attempt to makeup for its financial shortcoming, is considering issuing POB to cover the more then $7 billion unfunded pension liabilities. State financial analysts claim they can avoid the mistakes other entities, such as Illinois and Pittsburgh, have made with a strict payment schedule and reinvesting earned revenue back into the pension system. Voters will have to approve the purchase of the bond (Terry, 2006).

However, West Virginia ranks almost dead last for proper pension funding and does not have the same stable tax base that Oregon has to fall back on. Nor is it likely to adjust its public retirement system, requiring the state to issue bonds for almost the full amount of its unfunded liabilities. This increases the risk associated with the bonds for the Appalachia state, as it will be more reliant on profitable market conditions (Young and Prunty, 2005). West Virginia’s current economic scenario makes it appear more likely that any dip in market forces will have it competing with Illinois for the title of largest unfunded liability and POB debt.

Conclusion

We believe that the UAAL is predominantly a problem at the state level. The power to determine benefit levels, establish employer contributions, and invest the funds is in the hands of the legislature and the ARMB. The state manages the primary functions of the pension systems and hands down directives to participating employers on the levels of increase each year. Because the state has full control of the system, local employers are forced to participate at the required level. We do not believe it would be prudent for the Municipality of Anchorage to use POBs for the UAAL.
At the state level, however, a pension obligation bond is a financing tool that may be used to defray unfunded pension costs. Pension systems measure assets on hand against the present value of projected liabilities over the long term. If liabilities exceed assets, the difference is known as the unfunded accrued actuarial liability. With lagging investments, returns, increases in health care costs, and actuarial revaluations, many public and private pension systems have found themselves significantly under-funded.

A properly structured POB program will minimize the risk that the interest rate on the POB will exceed the investment returns on the proceeds of the POBs. Such structure is achieved by 1) issuing the POBs at the lowest rates possible in light of the Alaska constitutional constraints on issuing “debt,” while utilizing as many “credit enhancements” as deemed prudent, and 2) investing the POB proceeds so as to yield the highest returns based on the prudent investor standard. So structured, the State may well determine that POBs are a valuable tool in reducing if not eliminating its UAAL.

**Recommendations**

The Municipality of Anchorage needs to work closely with the governor and the legislature to promptly address the UAAL. This unfunded liability will only worsen with time. We believe that the State of Alaska needs to appropriate the entire amount of the current UAAL to fully fund the PERS and TRS systems. The State is primarily responsible for the current situation and is certainly the governmental body to remedy it. Passing the burden down to local governments is simply unmanageable. The State needs to take the leadership role in finding a solution. Enabling legislation such as HB 278 is a step in that direction.
POBs should be viewed as a tool that the State should utilize in managing its current UAAL. The use of several financing mechanisms, including POBs, is important since a large portion of the UAAL is due to post-employment health care benefits. POBs may provide savings as well as serve as mitigation between the negative budgetary impacts of paying down the UAAL over future fiscal years. Given current market conditions, POBs may serve the State as a tool to efficiently fund its pension system as well as manage the required future contribution rate increases.

Even with the risks associated with POBs such as arbitrage, leverage, and market and political risks, POBs offer an opportunity to more efficiently fund the pension system as well as manage the required future contribution rate increases to bring PERS and TRS to more appropriate funding levels.

If the Municipality were to issue POBs, there are a number of political questions to be considered:

- Does the Municipality want to substitute “hard” debt for “soft” debt? How much can it afford without negatively impacting its credit capacity and ratings?
- How much will it cost to issue the POBs, and what will be the rate of interest? Should the POBs be issued by the Municipality or by the Municipal Bond Bank?
- What are the investment advisors predicting for anticipated investment yields, based on conservative, prudent assumptions?

Finally, a risk-reward analysis needs to be conducted. Previously, interest rates were low and the market was booming. This made a decision to use POBs more palatable. Currently, however, it will be more difficult to decide the prudent degree of risk that local governments should incur. The State is in a stronger position to bear that risk.
Calculating the risk was outside the scope of this project, thus making it hard to quantify the risk or to determine what would be a prudent level of risk for the Municipality, or any other local government, to incur. We are confident that the risk should be reduced, or completely eliminated (based on the “fairness” issue), at the State level.
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