

A large, stylized graphic of a horse's head in shades of blue, facing right, serves as a background for the text. The horse's mane is depicted with flowing, curved lines. The overall design is clean and professional.

Overview of Pension Obligation Bonds

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What are POBs?

- POBs are debt instruments issued by a governmental entity to fund all or a portion of the Unfunded Actuarially Accrued Liabilities (“UAAL”) for pension and/or Other Post Employment Benefits (“OPEB”).
- POBs convert a soft balance sheet liability to a hard balance sheet liability.

What States have Issued POBs?

- Connecticut (2007)- \$2.0 billion (GO)*
- Illinois (2003) - \$10.0 billion
- Kansas (2004) - \$500 million
- New Jersey (1999) - \$2.8 billion
- Oregon (2003) - \$2.1 billion
- Puerto Rico (2007) - up to \$8.0 billion*
- West Virginia (2007) - \$911 million (MSA)
- Wisconsin (2003) - \$1.7 billion

– * Expected to be issued in the fall of 2007

Benefits

- Provides cash to the Retirement Systems to invest now to lower the unfunded liability and meet future benefit payments.
- Discipline to budget annual debt service payments to cover the new obligation.
- Expected annual funding cost reductions between 15%-30% due to the difference between actuarial assumed return versus interest paid on the bonds.

Concerns

- The primary risk is the failure that the actual return on the purchased investments is less than the funding cost of the debt over the life of the bonds, resulting in additional future payments.
- Reduced budget and financial flexibility in the event of an economic downturn that could impact other service levels.

Concerns (continued)

- Cannot be issued on a tax-exempt basis under the Internal Revenue Code.
- To achieve the lowest funding cost, it may be necessary to use derivative products that may carry other risks, such as counter-party credit risk and early termination risk.

Rating Agency Views

- Factors influencing Pension/OPEB Liabilities impacts on state credit profile:
 - State's current credit situation
 - Trends in historical funding pension funding levels
 - Absolute level of reported GASB 43/45 numbers are not the primary concern
 - Portion of the operating budget consumed
 - Relationship to general level of state wealth such as personal income

Rating Views (Continued)

- Primary questions asked by the rating community:
 - Has the state measured its liability?
 - Has the state evaluated the liability and acknowledged the challenges?
 - Has the state developed a comprehensive plan?
 - Has the state developed milestones along the path back to optimal funding levels?
- Average governmental funding levels are **81.8%** (Standard & Poor's Report 2/27/07)

Rating Views (Continued 2)

- The benchmark funding level for public pension funds is approximately 80% given the continuously moving assumptions associated with these liabilities.
- There are no real benchmarks for OPEB liabilities at the present time, due to limited reporting and volatility of these liabilities.
- A goal to steadily increase the percentage of the OPEB Annually Required Contribution would be viewed favorably.

Rating Views (Continued 3)

- Pension Bonds can be part of the solution:
 - Conversion of soft liability to a hard liability.
 - Will POBs debt service crowd out other pressing needs?
 - Will there be checks and balances to avoid a return to inadequate funding levels?
 - Has the state conducted a probability analysis that the assumed levels of return can be achieved versus fixed funding cost?

Rating Views (Continued 4)

- Use of proceeds is the key issue: pay current benefits, i.e. a payment holiday?
- POBs will be included in the state's Net Tax Supported Debt computation by all three of the rating agencies.
- Use of POBs alone should not result in a rating action if the funding plan is sound and well communicated.

Current Markets

- Broad investor demand both domestic and in Europe.
- Estimated all-in funding cost of ~ 6.07%.
- Level Debt Service per \$1 billion borrowed:
 - 20 years = ~ \$87.8 million annually
 - 30 years = ~ \$73.1 million annually
- If Systems investment returns of 7.75% can be achieved, then approx 1.75% or \$17.5 million annual savings per \$1 billion.

Summary

- POBs are a viable tool for funding a portion of the Commonwealth's pension liabilities.
- POBs are not a silver bullet, but...
- If used as part of a comprehensive plan and all other things being equal POBs should not affect the state's credit rating.
- POBs will likely limit future debt capacity.