# A Strategic Approach to Issuing Pension Obligation Bonds

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## THE PROBLEM

As any local government official knows, pension liabilities are a mounting problem for municipalities throughout the State of Illinois (the State). According to the Illinois Municipal League (IML), as of the end of 2020, over $30 billion of pension liabilities across more than 650 different public safety pension systems fall on the shoulders of local municipalities and the limited forms of revenue available to them. While $16.8 billion of these liabilities are currently funded, the remaining $13.3 billion are not funded. Furthermore, this unfunded liability may continue to grow as actuarial assumptions evolve and the compounding effect of the current unfunded liability takes its toll on future liability calculations.

There are different strategies available to local municipalities to address this growing problem, however, most of them include significant increases to the current level of pension contribution payments. While increasing contribution payments directly addresses the pension underfunding issues, it simultaneously creates another problem. For many municipalities, increasing payment contributions is not affordable. Every dollar that goes toward the pension problem takes a dollar away from other services that taxpayers expect from their local governments.

## A SOLUTION

One available tool that both addresses the problem of a community's unfunded pension liability and limits the growth of contribution payments is the issuance of taxable pension obligation bonds (POBs). There are certainly risks to issuing POBs, but their benefits are hard to ignore. As a result, a growing number of communities throughout the State have either considered issuing POBs or completed them in the past two years. As municipal advisor, PMA has provided financial advisory services to three different municipalities on the issuance of POBs since January 2021 and the remainder of this article highlights three features our clients found helpful throughout the bond issuance process.

## BUDGET STABILIZATION FUND

The first feature is the establishment of a budget stabilization fund (BSF). While the specific size of this fund varies from one issuer to the next, the fundamental idea is that the BSF helps address increasing contribution payments that may be higher than expected for various reasons, including changing actuarial assumptions and/or poor investment performance during periods of economic volatility. The BSF is established with the proceeds of the POBs and are invested separately from the pension funds. Furthermore, the proceeds are restricted and can only be used to make pension contribution payments or pay debt service on the POBs. They are controlled by the underlying municipality; however, they cannot be redirected toward other obligations of that municipality.

## FUNDING TARGET

A second feature is the idea of funding the pension fund to 100% by 2040 (current State law requires 90% funding by 2040) but using POBs to fund the pension fund only to 90% at the time of issuance. The remaining 10% would be funded on an annual basis until 2040 by the municipality. The merits of this approach are multi-faceted, and essentially serve as a hedge against the risks that are inherent to the bond issue.

First, given the smaller size of the POBs, the municipality would be exposed to less investment risk should the proceeds of the POBs be invested at an inopportune time or in underperforming assets.

Second, this structure provides flexibility to the municipality that may not be afforded with a larger bond issue. While the annual debt service payments are a hard liability (at least until the call date of the POBs), the contribution payment to fund the remaining 10% of the liability would be considered a soft liability. Therefore, in years when the municipality might generate a surplus, a larger contribution payment could be made, and conversely, in years when a surplus may not be available, the municipality would have the flexibility to make a smaller contribution payment.

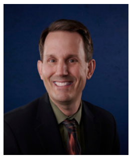
Third, funding only to 90% with the POBs mitigates the risk of overfunding. If 100% funding is met with the issuance of the POBs and other criteria are also met (e.g., investment returns exceed the assumed performance), then the pension fund would be overfunded. While that is not necessarily a problem, it does reflect an overallocation of funds to the pension fund when such overallocation is not needed. It also means that the bond issue, and the corresponding debt service payments, did not have to be as large as it was.

## CREDIT RATING IMPACT

Finally, the third feature of POBs is related to the credit rating process. The issuance of POBs will not automatically improve or deteriorate a municipality's credit rating. It is imperative, therefore, that the issuance of the POBs constitute one part of a more comprehensive approach to address the unfunded pension liability. If this is not the case, it is possible that the credit rating agencies may view the issuance of POBs in a punitive manner. In fact, PMA is aware of at least one municipality (a non-PMA client) that issued POBs in 2021 that received a credit downgrade from Moody's. On the other hand, a PMA client received an outlook upgrade when it issued its POBs. The rating report for the PMA client stated that the improved outlook was because a potential "structural imbalance" had been mitigated. While the report did not specify what had changed to mitigate the structural imbalance, it can be concluded that the issuance of the POBs created a level structure of future contribution payments that would be far more manageable for the municipality than if the POBs had not been issued.

## CONCLUSION

While there are notable risks that need to be disclosed and considered in the issuance of POBs, a growing number of municipalities in the State have concluded that the benefits outweigh these risks. These benefits are particularly attractive when POBs are issued with a strategic approach as outlined above that mitigates the risks that might otherwise prohibit a community from taking action. If you and your municipality would like to have a more detailed discussion on the potential risks and benefits of POBs, please reach out to a PMA advisor below.



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