Unfunded Actuarial Liability Resolution Program

Guide to Understanding **Pension Obligation Bonds**

The purpose of this guide, created as part of PERS' Unfunded Actuarial Liability (UAL) Resolution Program, is to help employers understand pension obligation bonds and how they can be used to affect their PERS contribution rates.

OREGON PERS
PUBLIC EMPLOYEES RETIREMENT SYSTEM

Contents

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Disclaimer

This guide is for employer educational purposes only and is not intended to provide legal or financial advice. If there is any conflict between this guide and federal law, Oregon law, or administrative rules, the laws and rules shall prevail.

About this guide

This guide aims to explain PERS information in as simple terms as possible; therefore, some actuarial information is simplified and may not apply to all situations or employers.

Terms colored cherry red are defined in the glossary at the end of this guide.

Term colored blue are links to websites or email addresses.

Assistance

If you have any questions or concerns about your specific scenario, email Actuarial.Services@pers.oregon.gov.

Introduction

The purpose of this guide is to explain what a pension obligation bond (POB) is and how employers can use it to help reduce their PERS net contribution rates. It explains the risks and benefits of POBs to help employers make an informed decision about issuing a bond.

About pension obligation bonds

A pension obligation bond (POB) is a taxable debt instrument that generates proceeds you can use to reduce your PERS net contribution rate. POBs create financial risk because they involve investing borrowed funds in risk-bearing, return-seeking investments. POBs ***leverage*** the effects of good or bad actual future returns on those investments.

A bond is a financial instrument that legally requires the borrower to repay investors who purchase the bonds. Bonds have debt service schedules specifying the payment of principal and interest, like home mortgages and car loans.

In Oregon, a POB is issued as a limited tax revenue bond under Oregon Revised Statute (ORS) 287A.150. Limited tax revenue bonds may be issued by resolution of the organization's governing body without voter approval. These bonds are typically repaid from general fund revenues.

Under federal tax law, POBs cannot be sold on a tax-exempt basis and therefore must be sold at a higher, taxable interest rate than what is typically available for capital project borrowings.

Local-government POBs cannot be issued as general obligation bonds; rather, they must be issued as taxable, limited obligation bonds.

Using POBs to help reduce PERS rate

For Oregon PERS-participating employers, POBs are usually issued to generate proceeds to fund a side account (learn more about how increasing assets improves unfunded actuarial liability (UAL) in *Guide to Understanding Unfunded Actuarial Liability*). The side account is then used as an offset to reduce the net contribution rate paid by employers for their employees' pensions. (Learn more about side accounts on the Employer Side Accounts webpage.)

The main reason PERS employers issue POBs is to seek to benefit from the leverage opportunity. If the invested POB proceeds earn a higher rate of return than the cost of funds invested (interest payable on the POB), your long-term contribution costs will be reduced.

If the actual returns on invested assets are lower than the cost of funds invested, the employer's long-term contribution costs will increase. Investing borrowed funds is a form of leverage, which amplifies the outcome of that investment decision.

IMPORTANT

The goal is to issue a bond with an interest rate that ends up being less than the actual rate of return on the proceeds invested in the PERS trust. This circumstance is not guaranteed, so the issuer may find itself in a worse financial position if debt servicing costs exceed the savings anticipated.

Requirements for issuing a bond

According to Oregon State Treasury, the 2019 Oregon Legislative Assembly took action to address concerns about the growing number of POBs being issued by school districts and local jurisdictions. It enacted ORS 238.697, which established prerequisites for issuing a POB and reporting requirements after the bond is issued.

It is best practice to seek advice from a financial consultant on how best to structure the bond to meet your financing needs before issuing a POB.

Before issuing the bond

To comply with ORS 238.697, before and after issuing a POB, you are required to complete the following steps:

1. Obtain a statistically based assessment from an independent economic or financial consulting firm to assess the likelihood that the investment returns on bond proceeds will exceed the interest cost of the bonds under various conditions.
2. Per ORS 287A.640, notify Oregon State Treasury's Municipal Debt Advisory Commission (MDAC) that you intend to issue a POB. To meet this requirement, complete the following and send to the MDAC at least 30 days before the bond issuance date:
    - MDAC Form PB1.
    - Statistically based assessment.
    - Confirmation of compliance with the requirements in ORS 238.697.
3. Make a report available to the public that describes the results of that assessment and discloses whether you retained the services of an independent SEC-registered advisor.

After issuing the bond

By issuing the bond, you assume the obligation to pay interest on the bond (called "coupon payments") until the final bond maturity (typically 20 years or more) and the principal of the bond at maturity. You specify the terms of the principal and coupon payments for the bond at the time of issue (based on the financial assessment and advice of financial professionals).

During the bond term (i.e., the period from bond issue until bond maturity), you are required to submit MDAC Form PB2 to the State Treasurer by December 1 every year. Information required on the form includes:

- The actual interest rate owed over the term of the POB.
- The projected rate of return on proceeds, as determined by the assessment.
- The actual rate of return on proceeds in the previous fiscal year.
- The cumulative rate of return on the bond proceeds.

Pension obligation bond rates of return

To assist employers with required reporting, PERS provides the average rate of return for side accounts in the previous year and the cumulative rate of return as of the current year. For current rates, go to the Side Accounts webpage and scroll down to the "Pension Obligation Bond (POB) Requirements" section.

Year pension obligation bond was established	Actual rate of return on proceeds in previous year	Cumulative rate of return
2019	-1.81%	44.78%
2020	-1.81%	27.09%
2021	-1.81%	18.57%
2022	-1.81%	-1.81%

Year	Annual crediting rate for side accounts
2019	13.92%
2020	7.18%
2021	20.76%
2022	-1.81%

Use of bond proceeds

Bond par amounts can be set to cover the entire UAL of the jurisdiction selling bonds, although some choose to issue less than the full amount of the UAL. As the bond issuer, you assume the obligation to pay interest (coupon payments) and principal until bond maturity (typically 20 years or more). The bond maturity cannot exceed the amortization period of the UAL, although it can be shorter.

After your bond has been issued and sold, you use the proceeds you receive to prepay pension obligations. You can do this by either funding a new side account or depositing more funds into an existing side account. The side account reduces your net contribution rate until the side account is exhausted.

For members of the State and Local Government Rate Pool (SLGRP): If you have a transition liability, PERS will use your bond proceeds to pay that down first. (See explanation at right.)

If you're interested in establishing a side account or have additional questions, email PERS Actuarial Services.

TRANSITION LIABILITY RATE

When an employer joins the SLGRP, a transition liability or surplus is calculated to ensure that each employer enters the pool on a comparable basis.

The transition liability is amortized over a fixed period and is expressed as a percentage of the employer's combined valuation payroll (i.e., Tier One/Tier Two plus OPSRP).

Your transition liability/surplus rate is a line item on your valuation report, as explained in *Guide to Understanding Your Valuation*, "Executive Summary Section."

IMPORTANT

Side accounts funded by POBs are not eligible to:

- Select a side account amortization period of less than 20 years.
- Receive matching funds from the Employer Incentive Fund.

Potential risks of POBs

Investment return volatility

POB funds are invested in the Oregon Public Employees Retirement Fund (OPERF) and are subject to market volatility. You do not have control over how your side account is invested. Investment returns may vary greatly from the assumed rate. If the OPERF earns an overall rate of return that is less than your borrowing cost, you will find yourself in a worse position than had you not borrowed. Largely because of investment return volatility risks, a GFOA Advisory from 2015 cautions that “State and local governments should not issue POBs.”

Decrease in available credit

Credit rating agencies may view the issuance of a POB negatively because it increases your bonded debt. This could reduce the funding available to you for other purposes.

Restrictive “call options”

Taxable debt may come with less favorable call options such as “make-whole” calls. This can make it more difficult and costly to refinance or restructure the bond than traditional tax-exempt debt. In recent years, taxable bonds have used more standard call provisions familiar in the tax-exempt market, but this may not always be the case.

CALL OPTION

A provision on a bond that allows the issuer to “call” or repay the bond before its stated maturity.

MAKE-WHOLE CALL

A make-whole call provision is a type of call option that compensates investors for interest lost because of prepayment.

STANDARD MUNICIPAL CALL

A provision that allows the issuer to prepay the bond without penalty at any time later than 10 years after date of issuance.

Side-account rules

When you deposit funds into a side account, you are unable to request a refund of those side account funds (it’s an “irrevocable trust”). This restricts you from using those funds if needed for other purposes.

Trends in POBs

Brief history

Oregon local governments first sold pension obligation bonds in the early 2000s to fund local issuers' unfunded actuarial liability (UAL) in PERS. Over time, issuance of bonds increased as more schools and community colleges wanted to reduce the rising costs of their UAL.

This option appeared attractive because of the gap between estimated long-term future returns for the OPERF and historically low interest rates available in the bond market. Oregon State Treasury expressed concern that the level of debt issuance might negatively impact the state's financial position.

In 2019, the Oregon Legislative Assembly enacted ORS 238.697 to address these concerns. The statute established new requirements for issuing a POB and annual reporting during the bond term.

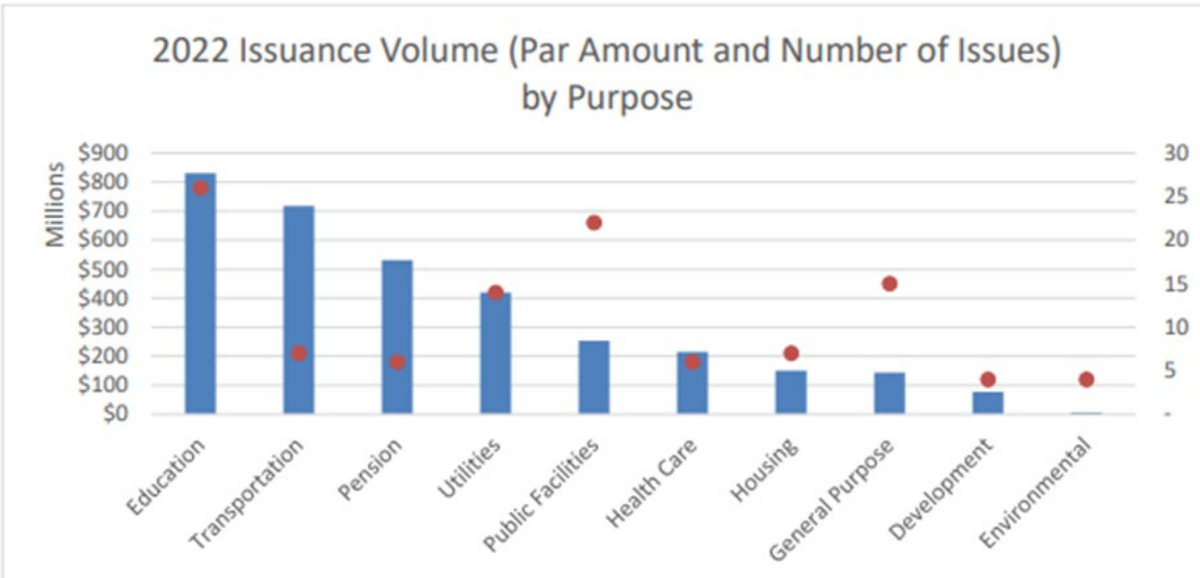
UNFUNDED ACTUARIAL LIABILITY

In simple terms, a UAL exists when a pension plan's liabilities (i.e., money the system owes to current and future retirees) are greater than its assets (i.e., money coming into the plan) at a given point in time. In other words, it is one measure of how much money should be contributed to pay for the past service benefits of current and future retirees.

An unfunded actuarial liability can occur any time something unexpected happens that measurably affects a plan's costs or earnings.

Local bond issuance by purpose

In 2022, Oregon local governments issued 111 bond offerings for all purposes. Pension obligation bonds were the third-largest category of issuance behind Education and Transportation. POBs had a face value of $531.7 million in six issues.



Source: *Municipal Debt Advisory Commission's (MDAC) 2022 Annual Report*

Visit www.oregon.gov/treasury/oregon-bonds/municipal-debt-advisory/ for more information about the MDAC.

Pension obligation bond resources

Center for Retirement Research at Boston College slp_40.pdf (bc.edu)

Municipal Debt Advisory Commission (MDAC) Report (oregon.gov)

Pension Obligation Bonds (gfoa.org)

Pension Obligation Bonds are a Bad Idea (umn.edu)

Pension Obligation Bond Financing (orrick.com)

Pension Obligation Bonds Increased (pewtrusts.org)

Pension Obligation Bonds: A White Paper (wulffhansen.com)

Glossary

Amortize/amortization

Amortization is an accounting technique used to spread costs over a set period of time.

Bond

A type of loan contract issued by a borrower to an investor. The bond specifies the interest rate and the maturity date.

Bond par

A bond's par value is its face value, the price at which it was issued. Most bonds are issued with a par value of $1,000 or $100.

Contribution rate

An employer's contribution rate is the percentage of payroll you pay to PERS to fund the pension benefits of your employees. It does not include the 6% employee (member) Individual Account Program (IAP) contribution, even if you are paying it on your employees' behalf.

Coupon

The interest payment that a bond issuer promises to pay a bondholder until the bond reaches maturity. A bond's coupon is expressed as an annual percentage of the bondholder's principal.

Debt instrument

A fixed-income asset that legally obligates the debtor to provide the lender interest and principal payments.

Employer Incentive Fund

Established by the Oregon Legislature in 2018. The purpose of the fund is to provide matching funds to employers who make lump sum deposits into employer side accounts under ORS 238.229.

General obligation bond

A municipal bond of which payment of interest and principal is backed by the taxing power and credit of the issuing governmental unit.

Limited tax revenue bond

A type of municipal bond authorized under ORS 287A.150. The issuer is required to use all legally available resources to meet its obligations.

Maturity

The length of time during which the owner will receive interest payments on the investment.

Side account

When you, an employer, make a lump-sum payment to prepay a portion of future employer contributions, the money is placed in a special account called a “side account." This account is attributed solely to the employer making the payment and tracked separately from other employer reserves.

Transition liability or surplus rate

When an employer joins the State and Local Government Rate Pool (SLGRP), a transition liability or surplus is calculated to ensure that each employer enters the pool on a comparable basis.

The individual employer’s funded status is compared to the funded status of the pool at the time of the employer’s entry.

- If the employer is better funded than the pool, the employer will have a transition **surplus**. This ensures the individual employer receives a benefit from being better funded at the time they joined the pool.

  The transition surplus for each employer is maintained separately from the SLGRP and is amortized over a fixed period via contribution rate offsets as a percentage of the employer’s combined valuation payroll.

- If the employer is less well-funded than the pool, the employer will have a transition **liability**. This ensures that the individual employer bears the cost of their lower funded status and that other pooled employers are not made worse off by the new employer joining the pool.

  The transition liability is amortized over a fixed period and is expressed as a percentage of the employer’s combined (Tier One/Tier Two plus OPSRP) valuation payroll.

Unfunded actuarial liability (UAL)

In simple terms, an unfunded actuarial liability (UAL) exists when a pension plan’s liabilities (i.e., money the system owes to current and future retirees) are greater than its assets (i.e., money coming into the plan). In other words, it is one measure of how much money should be contributed to pay for the past service benefits of current and future retirees.

An unfunded actuarial liability can occur any time something unexpected happens that measurably affects a plan’s costs or earnings. Maintaining a reasonable UAL is a normal part of a pension plan, and having a UAL does not necessarily mean that a plan isn’t financially healthy.