Testimony of David A. Volpe CFA
Before the Pennsylvania Senate Finance Committee
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Good afternoon, my name is David A. Volpe, CFA. I am currently a partner and portfolio manager with Emerald Advisers, a $2.5bn asset management firm located in Leola Pa. I am also President of LHV Financial Advisers, a firm that assists governmental entities on bond issuance and financial matters. While I currently spend the majority of my time as a portfolio manager for Emerald, in the 1990s I was the First Deputy City Controller of the City of Philadelphia – a jurisdiction with significant experience in the topic I am here to discuss today – Pension Obligation Bonds (POBs). I am not here to voice my support for or against the use of POBs, merely to discuss, based on my experience and review of selected transactions and literature, some of the issues that need to be fully vetted before making a critical decision to issue these types of securities.

Just what is a POB? Pension Obligation Bonds are taxable issues that are used to refinance all or a portion of a pension plans unfunded accrued actuarial liability. The proceeds from the bond sale are deposited in the pension fund and are invested according to the pension fund's investment policy. The issuers periodic unfunded accrued actuarial liability is replaced with principal and interest payments to bondholders – this is important as the issuance of the POBs takes a "soft" pension liability and turns it into a "hard" debt service liability. The issuer hopes the net effect is to lower and/or restructure its annual budgetary payments. The actual financial benefit (in terms of the cash flow difference between the actuarial requirement and bond payments) cannot be fully determined at the time of issuance and is a function of a number of factors including the interest cost on the bonds issued, timing of the investment of the proceeds in the pension fund, the Fund's asset allocation, and most importantly future investment performance.

Pension Obligation Bonds have been around in some form or fashion since the early 1980s when the City of Oakland, CA issued the first POBs in order to assist that community with funding its troubled pension system. The 1990s were the boom years of POBs with literally tens of billions of dollars in bonds issued based on the ability to invest bond proceeds at a higher rate than the cost of borrowing. According to the Center for Retirement Research at Boston College, governments across the country borrowed a total of $53 billion to fund pensions between 1986 and 2009. Prior to 1986 the bonds were allowed to be issued as tax exempt securities, and thus governments could immediately lock in an arbitrage profit by issuing tax exempt POBs and purchasing taxable risk free securities – the Tax Reform act of 1986 ended this arbitrage benefit. The 1990s saw an incredible run in the equity markets and a reduction in taxable interest rates, in addition to an increase in the risk pension plans were willing and allowed to take in terms of equity and alternative investments. This combination of factors led to a dramatic increase in the issuance of POBs as governments gained more means to generate returns and take on risk.

What entities have historically issued POBs? In most cases issuers have generally been jurisdictions that need to reduce their unfunded actuarial accrued liability payments due to budgetary stress and/or need to reduce or restructure/smooth their amortization payments. States and municipalities with well-funded pension plans and large budgetary surpluses are rarely the types of entities that issue POBs. Philadelphia was one of the jurisdictions that saw a need to issue POBs and in 1999 issued $1.25 billion which cut the pension fund's unfunded liability substantially. Philadelphia's POBs were issued at 6.61% interest rate with the City hoping that the invested proceeds would meet the pension fund's 9.0% actuarial return assumption in place at that time and generate healthy budgetary savings. Given the timing of the bond issuance it is no surprise in hindsight that the leverage worked against the pension fund with the City having a funding level of about 50% before the transaction, reaching close to 80% immediately after the transaction and round-tripping back to the low 50%s in 2006. In Philadelphia's case the stock market downturn was particularly difficult to digest as the City's unfunded actuarial liability payments were scheduled to ramp up significantly over that decade, while simultaneously the POB debt service payments were scheduled to gradually increase. The Administration in the City of Philadelphia started considering another POB in the spring of 2008. In my role as Financial Advisor to the City controller, the Controller's Office came out very strongly against this transaction. Fortunately, given the timing of the proposed POB, as well as the fragility of the City's finances and concomitant inability to absorb risk, that transaction was shelved.

So Philadelphia, in retrospect, had a problem with the timing of the issue, as well as ongoing budgetary stress, high and growing debt service and pension payments and a large retiree population that really did not make it a good candidate for a POB transaction. Due to the City's relatively low credit rating it also paid more for its POBs than a higher rated jurisdiction would have paid. The City of Allentown considered issuing POBs but decided instead to sell its water system to a regional authority and use the proceeds to plug that jurisdiction's burgeoning unfunded pension liability.

The previously mentioned Center for Retirement Research at Boston College lists the following considerations for the issuance of POBs 1) Financial - the success of POBs depends on the premise that pension returns are, on average, more than the cost of financing the debt, 2) Market timing - as my Philadelphia example shows, POBs involve considerable timing risk. The authors of this study note dollar cost averaging proceeds or issuance during recessionary periods would be a better approach, 3) Flexibility – while the issuance of a POB does not change the total indebtedness of the sponsor, it does change the nature of the indebtedness. Without a POB in place the amortization of unfunded liabilities may be amended to extend the amortization, defer payments etc. <u>With a POB pension bond payments are inflexible</u>, 4) Political – If the government uses the POB to fully fund the pension system political risk could occur in the form of a call for benefit increases despite the fact that the underfunding still exists. While the issuance of POBs may be politically expedient in the face of benefit cuts, elected officials must recognize the potential political risk associated with calls for benefit increases after POBs are issued and pension plans are seen as better funded.

What is the impact of a POB on a jurisdictions credit rating? Moody's Marcia Van Wagner issued an announcement on December 11, 2012 stating "Pension obligation bonds rarely improve the credit quality of the issuer. Governments contemplating pension bonds must sift through a number of factors influencing their decisions, including the specifics of their pension plans and the structure of the bonds. However, pension bonds are often a red flag associated with greater rigidity of long-term obligations, failure to find sustainable solutions to pension funding and a pattern of pushing costs off into the future… most pension bonds have, at best, a neutral impact on our overall assessment of an issuer's credit quality." On the positive side, Moody's has also stated "Issuance of pension bonds could be part of a broader credit-positive effort aimed at restoring balance between the pension's actuarial liabilities and asset values and achieving affordability."

So what type of governmental entity should be considering issuing POBs? First and foremost entities with significant political will to make POBs just one part of a broader overall strategy to manage pension expenses may be candidates for POB issuance. POBs can cause a sense of complacency among elected officials as the pension funding status improves as a result of the bond issue. This political will to forego current and future benefit increases is probably the most critical element of determining the government's likelihood of success in issuing POBs.

Second, entities should only consider issuing POBs when they have the financial strength and flexibility to float POBs when equity markets are to the significant downside as well as a strong enough credit rating to issue bonds at a favorable rate. Conversely, jurisdictions with high debt burdens as a percentage of governmental revenue and hence likely lower credit ratings are not necessarily good POB candidates, as POB debt is a hard debt and lower credit ratings will normally result in a higher interest cost on the bonds. For example, the City of Boulder Colorado issued POBs in 2010 and then income averaged the proceeds into their pension plan. Boulder also received a low 4.29% interest rate and had previously restructured its pension plan in a manner similar to what Pennsylvania is proposing today. The likelihood is that this will be a successful POB transaction.

Third, in addition to the financial and budgetary flexibility to choose the time to issue bonds, the ideal POB issuer should have a pension plan with an asset allocation that can sustain the risk necessary to satisfy the actuarial assumption needed to exceed the bond interest rate over time. Extra scrutiny should be given to situations such as: Governments with pension plans having large percentage of retirees vs. active employees that may have difficulties with POB issues given the large employer contributions that are associated with these plans as well as large cash requirements related to monthly benefit costs. In addition, it is important that POB issuance does not reduce the issuer's bonding capacity for other projects and place undue stress on the on the government's budget in times of poor market performance.

The Center for Retirement Research concludes their paper by noting the following: "it appears that POBs have the potential to be useful tools in the hands of *the right government at the right time.* Issuing a POB may well allow well-heeled governments to gamble on the spread between interest rate costs and asset returns or to avoid raising taxes during a recession. Unfortunately, most often POB issuers are fiscally stressed and in poor position to shoulder the investment risk. As such, most POBs appear to be issued by *the wrong governments at the wrong time*."

I would be happy to answer any questions you have at this time.