

Pension Obligation Bond Issuances Continue To Increase In 2021

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Key Takeaways

- Pension and other postemployment benefit (OPEB) obligation bond (POB and OOB) issuance is accelerating in the U.S.
- Factors driving issuances include a favorable interest-rate environment and issuers' desire to control contribution escalation.
- Key credit concerns, while unique to each U.S. public finance (USPF) issuer, primarily include market returns falling short of expectations and pension contribution increases pressuring budgets.
- Obligations that aim to address pension liabilities might come in different forms, but with similar credit risks.

POB Issuance Accelerates

The prevalence of debt issuances to address unfunded pension liabilities continues to increase in the current low-interest-rate environment. From Jan. 1, to Sept. 15, 2021, S&P Global Ratings rated 64 new POB issuances in the USPF sector totaling nearly \$6.3 billion; this is a 113% increase in rated POB issuance over the \$3.0 billion issued in the entire calendar 2020.

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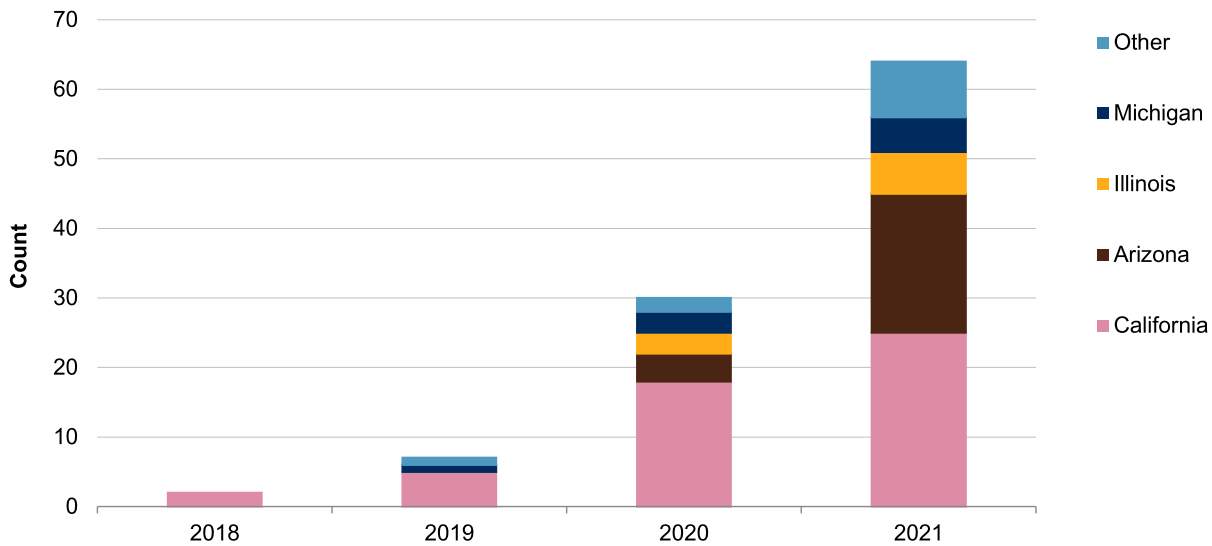
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Count Of POBs Rated By S&P Global Ratings



POBs--Pension obligation bonds.

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California is still the state that has issued the most POBs, although its share has decreased now that other states have increased their new issuances. We expect continued issuance accelerations as issuers compare peers' seemingly successful transactions with their own large and growing unfunded liabilities, and some issuers might anticipate the end of record low interest rates. The recession and economic disruptions associated with the COVID-19 pandemic serve as reminders of the importance of monitoring volatility in both markets and major revenue streams. Issuers are working to stabilize annual pension and OPEB costs through debt issuance. They are also finding this an opportune time to restructure or revise plan assumptions and contribution methodologies to reduce cost deferrals. While POB issuances appear aimed at fixing annual costs associated with pension plans, only time will tell if plan assumptions, including investment return benchmarks, can be realized and if the issuances themselves will provide long-term cost savings.

What's Different In 2021?



Different security pledges

The majority of pension obligation bonds (POBs) rated are on par with the general obligation (GO) or general creditworthiness of the issuer stemming from a pledge of legally available funds, or its full faith and credit. However, some issuers have used different pledges, including lease appropriations and revenue pledges. See appendix for details.



Different issuer types

POBs are typically generated from local governments, but we've seen an increase in other issuance this year, including school districts, park districts, states, and many protection districts. See appendix for details.



Different solutions

In lieu of placing POB proceeds in the pension trust to recognize an immediate impact on the funded ratio, as is typical, some issuers have elected to deposit proceeds into a supplemental account for the purpose of mitigating future budgetary stress stemming from pension contributions. An example of this is Tucson, Ariz., which has deposited a \$660 million issuance into an IRC Section 115 trust. These are not listed in the appendix since they are not POBs.

Source: S&P Global Ratings.

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The Unique Credit Risks Of POBs And OOBs

POBs and OOBs are taxable obligations that U.S. states, local governments, and other public entities use as a means to address unfunded pension liabilities by issuing debt to fund them and attempting to capture returns between portfolio investments and debt service costs. Rather than oversimplify our credit viewpoint of obligation bonds by expressing a generalized positive or negative view, we look at the individual issue at hand. With an understanding of why the bond is being issued, we analyze the changing credit picture and review management plans to mitigate the associated risks, including changes to plan benefits, contribution methodology, and actuarial assumptions.

Our Views On U.S. Public Finance POBs And OOBs

▼ Risks

- Issuer's environment of fiscal distress leads to perceived necessity to maintain budget or provide short-term relief.
- Issuer expects interest rate arbitrage without considering additional risks.
- No long-term measures set up to avoid imbalance that led to current poor funding situation.
- Debt capacity is reduced to a level that hinders typical operations.

▲ Opportunities

- Actions taken to mitigate new risk impact from issuance on budget.
- Issuance used to reduce pension contribution volatility or escalation risks.
- POB is paired with long-term funding solution.

Source: S&P Global Ratings.
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POB issuance does not absolve the issuer of pension plan risks. Generally, we believe transactions seeking to refund a pension liability for present-value savings will often not result in savings given the likelihood of poor investment performance, experience, or other changes that could generate new liabilities greater than projected at the time of issuance. In addition, an increased spread does not mean free money; it indicates increased exposure to market volatility risk when proceeds are deposited into the pension trust. Below, we evaluate how an issuer might assess and incorporate the risks associated with market volatility and detail some of the risks involved both with pensions and the debt financing pensions. Often, we see some of the expected interest savings from issuance used with the intention of offsetting some of these risks.

POB issuance does not absolve the issuer of pension plan risks.

Market timing risk

A significant amount of money placed into the market increases exposure to near-term market movement. If markets do not perform to expectations, pension liabilities could grow, potentially defeating the purpose of issuance. Some mitigation techniques we've seen include spreading out the deposit to reduce the likelihood that the deposit is made at a low point in the market and establishing a set-aside reserve fund, often an IRC Section 115 trust dedicated to pensions, to supplement planned contributions and ease the impact on the general fund. The most well-defined set-aside funds tend to have strict definitions of when the balance can be drawn and how funds are invested, and include replenishment clauses as well as dissolution guidelines as the plan approaches full funding.

Cost escalation risk

Pension contributions could escalate over time in the form of either planned amortization payments that increase with expected payroll growth or unplanned increases due to poor experience against risky assumptions. Cost escalation can be a budgetary challenge for issuers to incorporate into their long-term budget planning. With bond issuance, this risk is often mitigated in part by defining the bond repayment schedule to not only be shorter than the pension

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amortization, but also closer to level dollar. These changes address costs earlier than under the current pension amortization schedule. Long-term cost savings typically stem from either plan changes or the creation of a cheaper new benefit tier for new hires.

Budgetary flexibility risk

Obligation bonds reduce debt capacity as well as create fixed cost burdens that typically have less flexibility than pension and OPEB annual contributions. This could create budgetary constraints and negatively affect an issuer's ability to manage unforeseen near-term liquidity needs.

Political risk

Pension plans that appear to be overfunded, even when calculated using a high discount rate, might result in the issuer facing calls to increase benefits that are perceived to be "affordable" despite risk to the sponsor. Some higher-rated issuers have set the bond issuance to fund to less than 100% while combining de-risking efforts with issuance to reduce the likelihood of appearing overfunded.

We Expect States Will Continue To Issue Obligation Bonds While Interest Rates Are Low

As we review credit concerns for each issuance we see, and its associated risks to the issuer's budget, we anticipate that low interest rates and accelerating pension costs will continue to spur USPF POB and OOB issuance.

Appendix

Issuer	State	Rating date	Amount (mil. \$)	Pension plan	Issuer type	Security pledge
Apache Cnty	AZ	May 2021	15	PSPRS	Local government	Pledged revenue
Arizona Fire and Medical Auth	AZ	Mar 2021	38	PSPRS	Protection District	Lease appropriation
Bullhead City Fire Dist	AZ	Feb 2021	35	PSPRS	Protection District	Lease appropriation
Casa Grande	AZ	May 2021	63	PSPRS	Local government	Pledged revenue
Central Arizona Fire and Medical Auth	AZ	Feb 2021	58	PSPRS	Protection District	Lease appropriation
Coconino County	AZ	Apr 2021	18	PSPRS	Local government	Pledged revenue
Copper Canyon Fire and Medical Dist	AZ	Feb 2021	7	PSPRS	Protection District	Lease appropriation
Cottonwood	AZ	Apr 2021	20	PSPRS	Local government	Pledged revenue
Douglas	AZ	Apr 2021	39	PSPRS	Local government	Pledged revenue
Glendale	AZ	May 2021	253	PSPRS	Local government	Lease appropriation

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Appendix (cont.)

Issuer	State	Rating date	Amount (mil. \$)	Pension plan	Issuer type	Security pledge
Golder Ranch Fire Dist	AZ	Jan 2021	28	PSPRS	Protection District	Lease appropriation
Highlands Fire District	AZ	Jan 2021	9	PSPRS	Protection District	Lease appropriation
Kingman	AZ	Apr 2021	39	PSPRS	Local government	Pledged revenue
Oro Valley	AZ	Apr 2021	18	PSPRS	Local government	Pledged revenue
Pima County	AZ	Apr 2021	300	PSPRS	Local government	Pledged revenue
Pinetop-Lakeside	AZ	Apr 2021	7	PSPRS	Local government	Pledged revenue
San Luis	AZ	Apr 2021	9	PSPRS	Local government	Pledged revenue
Superstition Fire and Medical District	AZ	Jan 2021	29	PSPRS	Protection District	Lease appropriation
Tempe	AZ	May 2021	364	PSPRS	Local government	Lease appropriation
Verde Valley	AZ	May 2021	10	PSPRS	Local government	Lease appropriation
Auburn	CA	Sep 2021	18	CalPERS (M/S)	Local government	GO
Buena Park	CA	Sep 2021	96	CalPERS (M/S)	Local government	GO
Central Marin Police Authority	CA	Mar 2021	27	CalPERS (M/S)	Protection District	GO
Chula Vista	CA	Sep 2021	349	CalPERS (M/S)	Local government	GO
Commerce	CA	Aug 2021	30	CalPERS (M/S)	Local government	GO
Corona	CA	Aug 2021	283	CalPERS (M/S)	Local government	GO
Corte Madera	CA	Aug 2021	19	CalPERS (M/S)	Local government	GO
Covina	CA	Aug 2021	73	CalPERS (M/S)	Local government	GO
Downey	CA	Aug 2021	114	CalPERS (M/S)	Local government	GO
El Segundo	CA	Jul 2021	152	CalPERS (M/S)	Local government	GO
Huntington Beach	CA	Jul 2021	364	CalPERS (M/S)	Local government	GO
Livermore Area Rec & Park Dist	CA	Apr 2021	13	Alameda County ERA	Park District	GO

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Manhattan Beach	CA	Jul 2021	91	CalPERS (M/S)	Local government	GO
Monterey Park	CA	Jul 2021	109	CalPERS (M/S)	Local government	GO
Orange	CA	Jun 2021	286	CalPERS (M/S)	Local government	GO
Red Bluff	CA	Jun 2021	20	CalPERS (M/S)	Local government	GO
Redondo Beach	CA	May 2021	213	CalPERS (M/S)	Local government	Lease appropriation
San Anselmo	CA	Jun 2021	9	CalPERS (M/S)	Local government	GO
San Fernando	CA	Jun 2021	40	CalPERS (M/S)	Local government	GO
Sanger	CA	Jun 2021	22	CalPERS (M/S)	Local government	GO
Santa Ana	CA	Jun 2021	421	CalPERS (M/S)	Local government	GO
Santa Cruz County	CA	Jun 2021	124	CalPERS (M/S)	Local government	GO
Stanislaus Consolidated Fire Protection Dist	CA	Mar 2021	11	CalPERS (M/S)	Protection District	GO
Whittier	CA	May 2021	144	CalPERS (M/S)	Local government	GO
Willows	CA	May 2021	9	CalPERS (M/S)	Local government	GO
Naugatuck Borough	CT	Jul 2021	61	Employee & Firemen's Plans	Local government	GO
West Hartford	CT	Jun 2021	324	Local plan	Local government	GO
Addison Fire	IL	Apr 2021	38	Local plan	Protection District	GO
Bensenville Fire Protection District No. 2	IL	Mar 2021	15	Local plan	Protection District	GO
DuQuoin	IL	Aug 2021	8	City Police/Fire Plans	Local government	GO
Elmwood Park	IL	Jul 2021	63	City Police/Fire Plans	Local government	GO
Geneseo	IL	Jul 2021	4	Police (SE)	Local government	GO
Wheaton	IL	Jun 2021	50	Local Police & Fire plans	Local government	GO
Kansas	KS	Jan 2021	503	KPERS	State	GO
Calhoun Cnty	MI	Sep 2021	24	Local plan	Local government	GO

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Ishpeming	MI	Jul 2021	9	MERS	Local government	GO
Roosevelt Park	MI	Jun 2021	3	MERS	Local government	GO
Vassar	MI	Jun 2021	5	MERs	Local government	GO
Westland	MI	Jun 2021	82	MERS	Local government	GO
Bridgeton	MO	Nov 2021	14	Local plan	Local government	Appropriation
Portland Public Schools	OR	Jan 2021	397	OPERS	School District	GO
Dauphin	PA	Aug 2021	55	Local plan	Local government	GO
Upper Chichester Township	PA	Aug 2021	32	Local pension and OPEB	Local government	GO
Norfolk	VA	Jun 2021	211	Local plan	Local government	GO

PSPRS-- Public Safety Personnel Retirement System. CalPERS--California Public Employees' Retirement System. ERA--Employees' Retirement Association. KPERS--Kansas Public Employees Retirement System. MERS--Municipal Employees' Retirement System. OPERS--Oregon Public Employees' Retirement System. OPEB--Other postemployment benefits. GO--General obligation.

Related Research

- Pension Brief: POBs See Increasing Activity In Low-Interest-Rate Environment, Oct. 14, 2020
- OPEB Brief: The Credit Impacts Of OPEB Obligation Bonds, March 11, 2019
- Pension Obligation Bonds' Credit Impact On U.S. State And Local Government Issuers, Dec. 6, 2017

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