Pension Obligation Bonds

Potential Benefits and Risks

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What Are Pension Obligation Bonds?

Pension Obligation Bonds (POBs) are taxable bonds issued by governmental entities to pay off all or a portion of its unfunded pension liabilities. POBs may be cost-effective when the interest rate on the bonds is less than the actuarial rate on the unfunded liability. There are potential benefits and risks associated with POBs that must be evaluated thoroughly.

What Are the Potential Benefits?

- Generate expected savings vs. current funding methodology given current taxable interest rate environment.
- Provide flexibility to level off future payments to more affordable levels (eliminates the Illinois pension ramp).
- Could prevent future reductions in the General Corporate Levy.
- Replace one existing legal obligation with another, less costly liability.
- Lower the hurdle rate on investments from the actuarial rate to the POB cost of funds.
- Comply with State funding requirements (90% by 2040).
- Pension plan receives upfront payment, instead of partial payments through 2040 (benefit from compound interest).

What Are Some of the Key Potential Risks?

- Actual earnings on invested proceeds over the life of the POBs will determine the final savings generated.
    - If the earnings on POB proceeds are less than the POB cost of funds, there would be no savings.

Actual Earnings Achieved		Result
Above Actuarial Rate	→	Savings Greater than Expected
Actuarial Rate	→	Expected Savings Received
Below Actuarial Rate, but Above POB Cost of Funds	→	Savings Less than Expected
POB Cost of Funds	→	**No Savings**
Below POB Cost of Funds	→	Loss

- Investing a large dollar amount all at once could result in adverse marketing timing.
- Poor investment performance in the years directly following a POB issuance could negatively impact long-term performance and the POB's profitability.
- POBs are "hard" liabilities while pension payments can be considered "soft" liabilities.

What Will NOT Change from POB Issuance?

- Ongoing financial commitments to the plan does not change.
    - Issuer continues to pay normal costs and remains responsible for any future unfunded liabilities that may arise.
- Additional UAALs may arise as a result of changes in mortality tables, payroll, asset valuation method, benefit levels, investment rate, etc.
- Potential legislation to extend the amortization period to 2050 (from 2040).
- Consolidation of the downstate pension plans will still take place.
- Actuarial assumptions have yet to be adopted by the Consolidation Boards.
- None of the benefits or programmatic aspects to the plan's participation are affected.
- None of the plan's assets are pledged to the POBs.

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