Potential Untapped Value IN CALIFORNIA'S PUBLIC RETIREMENT SYSTEMS

California's public employee retirement systems may be failing to capitalize on the value of one of their greatest assets: Their creditworthiness.

"The California Constitution instructs that public retirement boards "shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims."

State, county and municipal plan sponsors parlay their own creditworthiness when they issue Pension Obligation Bonds ("POBs"). If they can issue bonds with an interest ("coupon") rate that is lower than their respective retirement system's assumed rate of investment return, they can immediately lower their expected retirement costs by transferring POB proceeds into the retirement system and paying down their unfunded liabilities. And, if the retirement system's investments return more than the coupon rate, the plan sponsor will have lowered its *actual* retirement costs with arbitrage profits. The risk of issuing POBs is that the retirement system's investment returns may underperform the coupon rate, which will lead to an increase in the plan sponsor's retirement costs. For the bond issuer, a lower coupon rate both decreases risk and increases the potential reward.

The fundamental question this article poses is whether, under current law, California is "leaving money on the table" by failing to allow its creditworthy public employee retirement systems *themselves* to issue bonds to support their own funding needs.

We hear so much about the underfunding "crisis" it is easy to forget that California public retirement systems are extraordinarily creditworthy from an underwriting point of view. That creditworthiness should have realizable value in the bond market. Consider the following:

- Even at the nadir of global investment markets in 2009, the *lowest* funded public retirement systems in California had enough money to pay all obligations projected to be due to their current retirees many years into the future. For example, only two of the twenty county retirement systems governed by the County Employees' Retirement Law ("CERL") ever dropped below a market-value funded ratio of 50 percent and none dropped below a market-value funded ratio of 45 percent. Contrast this with plan sponsors like Vallejo, San Bernardino, and Stockton.

- Because a public retirement system's obligations are backed by the statutory funding obligations of plan sponsors, there is a double back-stop to the system's creditworthiness: (1) The assets of the retirement system itself and (2) the future funding obligations of the plan sponsors, which retirement boards adjust annually to maintain the actuarial soundness of their retirement systems.

- The plan sponsors would not be taking on any new creditors; they would just continue to have their *existing* contingent funding obligations to the retirement systems. The retirement systems would not be lending their creditworthiness to the plan sponsors; they would just be extracting value from their *own* creditworthiness for *themselves*.

- Conditions could be placed on the systems' obligations to bondholders to protect the priority rights of the systems' members and beneficiaries, without significantly impairing the value of the bonds to potential buyers. For example, payment to bondholders could be *temporarily* suspended when a system's funded ratio falls under a certain threshold (e.g., 30 percent) *and* the retirement board determines that payment on the bonds jeopardizes the payment of benefits.

- Conditions could be placed on a retirement board that issues bonds in order to lower risk for the retirement system and the bond holders. This could include, for example, a maximum assumed rate of investment return (e.g., six percent) and a maximum amortization period for the system's unfunded actuarial accrued liability (e.g., 15 years). This could keep a board's borrowing within prudent boundaries meant to assure its ability to fully fund promised benefits and timely repay its obligations to bondholders.

It seems that such "Pension Funding Bonds" ***issued by a public retirement system*** likely would be attractive to the bond market at a lower coupon rate than traditional POBs issued by state, county or municipal plan sponsors. The lower coupon rate would increase the margin for error in comparison to traditional POBs.

> *"Why should California's public retirement boards not be permitted to utilize an investment strategy that other similarly situated investors utilize?"*

The California Constitution instructs that public retirement boards "shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims." Cal Const., art. XVI, § 17(c). Other investors with billions of dollars in assets and strong creditworthiness reasonably may consider using prudent levels of leverage to improve their investment returns. Why should California's public retirement boards not be permitted to utilize an investment strategy that other similarly situated investors utilize? Enacted after 9-11, Government Code section 31603 already allows county retirement boards to borrow in a financial crisis in order to ensure timely benefit payments and provides that the "costs associated with securing and repaying the loan, including interest, shall be a charge against investment earnings of the fund." Why should the law prevent our public retirement boards from borrowing as part of a prudent investment strategy absent emergency circumstances?

The viability of Pension Funding Bonds will depend upon a number of factors, such as (a) the bond market's assessment of the borrower's cash flow and default risk, (b) actuarial input regarding the impacts on employer contribution volatility, (c) IRS approval, which may require federal legislation, and (d) whether the interest returns on the bonds could be tax free under existing or amended law to make them more attractive to the bond markets. Legislative and/or constitutional changes would be necessary for a retirement board to prudently consider issuing the types of bonds described in this article. To begin a discussion, I propose the following foundational terms that might be added to California Constitution article XVI and/or within California public retirement systems' governing statutory schemes.

Satisfying obligations arising out of the issuance of pension funding bonds that comply with the following conditions and otherwise comply with law shall be considered a reasonable expense of administering the system under California Constitution, article XVI, section 17(a):

1. The retirement board must determine that the issuance of the pension funding bonds is consistent with its fiduciary obligations set forth in California Constitution, article XVI, section 17.
2. The retirement board must hold all proceeds from the issuance of pension funding bonds in the retirement system's accounts and thereafter such funds may be used only for the exclusive purposes set forth in California Constitution, article XVI, section 17(a).
3. The retirement board must maintain an assumed rate of investment return for projecting the growth of the system's assets that is not greater than six percent while the system has any obligations to any bond holders.
4. The retirement board must maintain an amortization period for the system's unfunded actuarial accrued liability that is not longer than 15 years while the system has any obligations to any bond holders.
5. The retirement board must adopt an annual actuarial valuation for the purpose of setting employer contributions to the retirement system each year while the system has any obligations to any bond holders.
6. A retirement system's payment obligations on pension funding bonds must be temporarily suspended if the retirement board determines that such payments endanger the timely payment of benefits to any participant or beneficiary of the public pension or retirement system. The retirement board may make such a determination, in the exercise of its discretion, only if the funded ratio of the public pension or retirement system is determined to be less than 30 percent on a market-value-of-assets basis in the retirement board's most recent annual actuarial valuation (or based on an interim valuation by the retirement board that uses the same assumptions and methodologies as the retirement board's most recent annual actuarial valuation). All suspended payments shall be made later, with interest at the pension funding bonds' coupon rate, at such time that the funded ratio of the public pension or retirement system is determined to be greater than 30 percent on a market-value-of-assets in the retirement board's most recent actuarial valuation.

Making Pension Funding Bonds a prudent option for retirement boards will require analysis and amendments to existing law far beyond what is presented in this article. Suffice it to say that the potential value proposition of Pension Funding Bonds is simple: The risk of default by a retirement system on the type of bonds described in this article should be much lower than the risk of default by a state, county or municipal bond issuer. And, that lower risk of default should translate to a lower coupon rate on the bonds, which may enable California to harvest value from the creditworthiness of its public employee retirement systems, to the benefit of those systems' members and beneficiaries, as well as California taxpayers.

Jeff Rieger *is Counsel with Reed Smith LLP and a senior member of its public pension practice. Rieger represents numerous state, city and county public retirement systems throughout California as fiduciary, general and litigation counsel.*