Public Pensions, Public Budgets and the Risks of Pension Obligation Bonds (POBs)

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Abstract

State and local governments have used pension obligation bonds (POBs) as a means of closing funding level gaps between public pension plan assets and liabilities while simultaneously reducing current pension expenditures. By issuing taxable debt, governments assume that the future returns on the bond proceeds will outpace the debt costs and save the government from making difficult decisions regarding tax increases or spending cuts. POBs, therefore, have become viewed as a potentially painless solution to funding shortfalls. The few existing analyses of POBs limit risk discussion to investment risk and assume that the long-term nature of public pension plan investing minimizes this risk. This understanding of risk either mischaracterizes the nature of risk in long-term investing, or misses other types of risk—including certain risks unique to government—altogether. For example, public pension liabilities are measured using an expected return on investment rather than a risk-free discount rate, thereby reducing the present value of liabilities. Finally, pubic pension funds and governmental general funds do not share common accounting measures of operations. Whereas pension funds report operations on an accrual basis like for-profit companies do, governmental funds report on cash or modified accrual bases of accounting. This difference in measuring the same phenomenon has implications in the decision process of whether to issue a POB. This paper seeks to frame an understanding of the risks and costs of pension obligation bonds within the unique structure of government operations and finance. Additionally, models of these risks are presented and quantified. A secondary goal of this paper is to determine which governments are using these financial instruments.