

AK LEGISLATURE FINANCE COMMITTEES FILES 2007-2008 3145

29

1 calculate a revised employer contribution rate for that employer in recognition of that
2 prepayment not more than 30 days following the prepayment.

3 * Sec. 2. AS 18.56.010 is amended by adding a new subsection to read:

4 (g) The legislature finds that permitting the Alaska Housing Finance
5 Corporation to create a subsidiary to assist in the financing of prepayment of all or a
6 portion of a governmental employer's share of unfunded accrued actuarial liability of
7 retirement systems serves a public purpose in benefiting the people of the state. The
8 Alaska Housing Finance Corporation may act on behalf of the state and its people in
9 serving this public purpose for the benefit of the general public.

10 * Sec. 3. AS 18.56.086 is amended to read:

11 **Sec. 18.56.086. Creation of subsidiaries.** The corporation may create
12 subsidiary corporations for the purpose of financing or facilitating the financing of
13 school construction, facilities for the University of Alaska, facilities for ports and
14 harbors, prepayment of all or a portion of a governmental employer's share of
15 unfunded accrued actuarial liability of retirement systems, or other capital
16 projects. A subsidiary corporation created under this section may be incorporated
17 under AS 10.20.146 - 10.20.166. The corporation may transfer assets of the
18 corporation to a subsidiary created under this section. A subsidiary created under this
19 section may borrow money and issue bonds as evidence of that borrowing, and has all
20 the powers of the corporation that the corporation grants to it. Unless otherwise
21 provided by the corporation, the debts, liabilities, and obligations of a subsidiary
22 corporation created under this section are not the debts, liabilities, or obligations of the
23 corporation.

24 * Sec. 4. AS 18.56.110(g) is amended to read:

25 (g) Notwithstanding AS 18.56.090(a)(11) and (a) of this section, the
26 corporation may not issue bonds in any 12-month period beginning after June 30,
27 1983, in an amount that exceeds the amount of bonds authorized to be issued during
28 the preceding period, unless a different amount is authorized by the legislature. This
29 subsection does not apply to

30 (1) the issuance by the corporation of refunding bonds;

31 (2) [OR TO] the issuance by the corporation of bonds the proceeds of

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28
29
30
31

which are intended to be used to refinance mortgage loans held by the corporation; or
(3) the issuance by a subsidiary of the corporation of bonds to
prepay all or a portion of a governmental employer's share of unfunded accrued
actuarial liability of retirement systems if the board of the subsidiary first finds
that the actuarially assumed rate of return on the funds managed by the Alaska
Retirement Management Board is projected to exceed the true interest cost to be
paid on the bonds by at least 1.5 percent annually.

* Sec. 5. AS 18.56.390 is amended by adding a new paragraph to read:

(14) "governmental employer" means the State of Alaska or a municipality or other state or municipal governmental entity within the state, including an agency, instrumentality, district, school district, public corporation, department, division, or other subdivision of the state or of a municipality, in its capacity as an employer.

* Sec. 6. AS 29.47 is amended by adding a new section to read:

Sec. 29.47.480. Accrued actuarial liabilities of retirement systems. (a) A municipality, or two or more municipalities jointly, may issue obligations to prepay all or a portion of each participating municipality's share of the accrued actuarial liabilities of retirement systems. A municipality, or two or more municipalities jointly, may enter into a lease or other contractual agreement with a trustee, or the Alaska Municipal Bond Bank Authority or a subsidiary of the authority, a subsidiary of the Alaska Housing Finance Corporation, the state bond committee, or the Alaska Pension Obligation Bond Corporation in connection with the issuance of obligations to prepay all or a portion of each participating municipality's share of the accrued actuarial liabilities of retirement systems. Obligations issued for purposes described in this subsection must be secured and payable as provided in the agreement or under an authorizing ordinance. The agreement or ordinance may provide for reserves and for protective covenants.

(b) Amounts paid by a participating municipality in connection with obligations issued under this section, together with proceeds of the obligations and interest or earnings, may be pooled into one or more funds or accounts, including one or more debt service funds. The assets in any of the funds or accounts may be pledged

1 to the holders of the obligations.

2 (c) A municipality may enter into a funds diversion agreement with a state
3 agency regarding payment of money on behalf of the municipality that may be applied
4 to payments under a lease, other agreement, or obligation issued under this section.
5 The funds diversion agreement must provide, subject to any conditions set out in the
6 funds diversion agreement, that all or a portion of the funds otherwise payable to the
7 municipality by the state agency shall be paid directly to the trustee, the Alaska Bond
8 Bank Authority, or its subsidiary, a subsidiary of the Alaska Housing Finance
9 Corporation, the state bond committee, or the Alaska Pension Obligation Bond
10 Corporation, to satisfy, in whole or part, the municipality's payments under the lease,
11 other agreement, or obligations. Nothing in this subsection or in a funds diversion
12 agreement entered into under this subsection obligates the state or a state agency to
13 pay any amount to or on behalf of a municipality that the municipality is not otherwise
14 entitled to receive or to make any payments of principal or interest on the obligations.

15 (d) For purposes of this section, "obligations" means bonds, notes, commercial
16 paper, certificates of participation, or other contractual obligations.

17 * Sec. 7. AS 36.30.850(b) is amended by adding a new subsection to read:

18 (45) contracts of the Alaska Pension Obligation Bond Corporation
19 under AS 37.16.010 - 37.16.900.

20 * Sec. 8. AS 37.15 is amended by adding new sections to read;

21 **Article 8. Pension Obligation Bonds.**

22 **Sec. 37.15.900. Bond authorization.** (a) For purposes of financing
23 prepayment of all or a portion of a governmental employer's share of unfunded
24 accrued actuarial liability of retirement systems, including the costs of issuance and
25 administration, the issuance and sale of bonds of the state by the committee is
26 authorized as provided in this section and AS 37.15.905 - 37.15.955. The net proceeds
27 of the sale of the bonds remaining after payment of costs of issuance and
28 administration shall be transferred to the commissioner of administration for the
29 account of the governmental employer whose share of unfunded accrued actuarial
30 liability is to be prepaid for application to that liability. Accrued interest paid on the
31 bonds shall be paid into the pension obligation bond redemption fund.

1 (b) The total unpaid principal amount of bonds, including refunding bonds,
2 but excluding refunded bonds, may not exceed \$5,000,000,000. The bonds do not
3 constitute a general obligation of the state. Authorization by the voters of the state or
4 the legislature is not required.

5 (c) The committee may enter into agreements with other state agencies as
6 necessary or convenient to implement this section and AS 37.15.905 - 37.15.955.

7 (d) The committee may contract for the services of underwriters, paying
8 agents, trustees, bond printers, rating agencies, bond insurance, credit enhancement
9 providers, accountants, financial advisors, and bond counsel, and for other services as
10 are necessary to accomplish the bond issuance and sale.

11 **Sec. 37.15.905. Bond redemption fund.** (a) There is established a special fund
12 of the state, known as the pension obligation bond redemption fund, which is a trust
13 fund for paying and securing the payment of the principal of and interest and
14 redemption premium, if any, on the bonds, and which shall be at all times completely
15 segregated and set apart from all other funds of the state. The committee, on behalf of
16 the state, may obligate and bind the state to set aside and pay into the bond redemption
17 fund, on a monthly or other periodic basis. The bond redemption fund shall be drawn
18 upon only for the purpose of paying the principal of and interest and redemption
19 premium, if any, on the bonds, together with related trustee fees, if any.

20 (b) Money in the bond redemption fund may be invested in the same manner
21 and on the same conditions as permitted for investing of money belonging to the state
22 or held in the treasury under AS 37.10.070; however, the committee may agree with
23 the bondholders to further limit these investments. Earnings on investments must be
24 retained in the bond redemption fund.

25 (c) Separate accounts may be created in the bond redemption fund for the
26 purposes of paying and securing the bonds. The accounts may be combined for
27 purposes of investment and for financial support to achieve the purposes of
28 AS 37.15.910(c).

29 **Sec. 37.15.910. Bond terms.** (a) The bonds may be issued and sold at public
30 or negotiated sale in the manner, in the amounts or series, and at the time or times that
31 the committee determines. The bonds, or each series of them, shall be sold at the price

1 and upon the terms, conditions, and covenants set by the committee after considering
2 market conditions. Interest rates may be fixed or variable.

3 (b) The bonds mature at the time or times fixed by the committee. The bonds
4 may be subject to redemption before their fixed maturities, as determined by the
5 committee, with or without a premium or premiums. The bonds may be in
6 denominations determined by the committee; may be issued in fully or partially
7 registered form; must be payable as to principal and interest at the place or places
8 determined by the committee; must be signed on behalf of the state in the manner
9 provided by the committee; and must be issued under and subject to the terms,
10 conditions, covenants, and protective features safeguarding payment of the bonds as
11 found necessary by the committee.

12 (c) If the committee finds it reasonably necessary, the committee may select a
13 trustee or trustees for the holders of the bonds, or any series of them, for the
14 safeguarding and disbursement of any of the money in the bond redemption fund or
15 for duties with respect to the enforcement, authentication, delivery, payment, and
16 registration of the bonds as the committee may determine. The committee shall fix the
17 rights, duties, powers, and obligations of the trustee or trustees.

18 (d) In its determination of all matters and questions relating to the issuance
19 and sale of the bonds and the fixing of their maturities, terms, conditions, and
20 covenants as provided in (a) of this section, the decisions of the committee shall be
21 those that are reasonably necessary for the best interests of the state and its inhabitants
22 and that will accomplish the most advantageous sale of the bonds. Decisions of the
23 committee, as expressed in a bond resolution, are final and are conclusively
24 considered to comply with the requirements of AS 37.15.900 - 37.15.955.

25 **Sec. 37.15.915. Bond resolution.** The committee shall authorize the issuance
26 of bonds by adopting a resolution and shall prepare all other documents and
27 proceedings necessary for the issuance, sale, and delivery of the bonds or any part or
28 series of them. The bond resolution must fix the principal amount, denominations,
29 date, maturities, manner of sale, place or places of payment, rights of redemption, if
30 any, terms, form, conditions, and covenants of the bonds or each series of them.

31 **Sec. 37.15.920. Enforcement by bond owner.** (a) The owner or owners of not

1 less than 10 percent of the aggregate principal amount of any series or issue of bonds
2 or the trustee for the owners of the bonds or any series of them may, by appropriate
3 proceedings in state court, require and compel the transfer, setting aside, and payment
4 of money and the enforcement of all of the terms, conditions, and covenants as
5 required and provided in AS 37.15.900 - 37.15.955, as appropriate, and the bond
6 resolution.

7 (b) A proceeding under (a) of this section may be commenced and conducted
8 only in the Superior Court for the State of Alaska, First Judicial District at Juneau.

9 **Sec. 37.15.925. Amounts required for payments.** The committee shall,
10 before June 30 of each year or from time to time within the year, as appropriate,
11 commencing with the year in which the bonds are issued, certify to the commissioner
12 of revenue and the commissioner of administration the amounts required in the current
13 fiscal year and the next ensuing fiscal year by the bond resolution or resolutions to be
14 paid from the general fund into the bond redemption fund and to be paid into and
15 maintained in any reserve fund or account or other fund or account created by the
16 bond resolution or resolutions, and shall also certify to the commissioners the last date
17 or dates upon which payments may be made.

18 **Sec. 37.15.930. Purposes and sufficiency of revenue.** The proceeds of bonds
19 may be used for the purposes described in AS 37.15.900(a), as appropriate. Bonds
20 may not be issued unless the committee first finds that the actuarially assumed rate of
21 return on the funds managed by the Alaska Retirement Management Board is
22 projected to exceed the true interest cost to be paid on the bonds by at least 1.5 percent
23 annually.

24 **Sec. 37.15.935. Refunding.** (a) The committee may refund the bonds or any
25 part of them at or before their maturities or redemption dates by the issuance of
26 refunding bonds of the state if, in the opinion of the committee, refunding is
27 advantageous to and in the best interest of the state and its inhabitants.

28 (b) The issuance of refunding bonds need not be authorized by the voters of
29 the state or by an act of the legislature. The committee shall adopt the resolution or
30 resolutions and prepare all other documents and proceedings necessary for the
31 issuance, exchange or sale, and delivery of the refunding bonds. All provisions of

1 AS 37.15.900 - 37.15.955 are applicable to the refunding bonds and to the issuance,
2 sale, or exchange of them, except as otherwise provided in this section.

3 (c) Refunding bonds may be issued in a principal amount sufficient to provide
4 money for the advance or current refunding of all bonds to be refunded and interest on
5 the refunded bonds and, in addition, for the payment of all costs of issuance and
6 administration of the refunding bonds. These expenses also include the difference in
7 amount between the par value of the refunding bonds and any amount less than par for
8 which the refunding bonds are sold; the premium, if any, necessary to be paid in order
9 to call or retire the outstanding bonds and the interest accruing on them to date of the
10 call or retirement; and other such costs. The committee is authorized to incur expenses
11 to carry out this section.

12 (d) The committee may contract with a refunding trustee to hold the proceeds
13 of refunding bonds in trust until the proceeds, together with earnings on the proceeds,
14 are applied to pay the principal of, premium, if any, and interest on the bonds to be
15 refunded. Until the refunding bond proceeds are applied, the proceeds may be invested
16 in direct obligations of, or obligations guaranteed by, the United States or an agency or
17 corporation of the United States whose obligations constitute direct obligations of, or
18 obligations guaranteed by the United States.

19 **Sec. 37.15.940. Bonds as legal investments.** The bonds are legal investments
20 for all banks, trust companies, savings banks, savings and loan associations, and other
21 persons carrying on a banking business, all insurance companies and other persons
22 carrying on an insurance business, and all executors, administrators, trustees, and other
23 fiduciaries. The bonds may be accepted as security for deposits of all money of the
24 state and its political subdivisions.

25 **Sec. 37.15.945. Statutory construction.** AS 37.15.900 - 37.15.955 shall be
26 liberally construed in order to carry out the purposes for which they were enacted.

27 **Sec. 37.15.950. Regulations.** The committee may adopt regulations necessary
28 to implement the provisions of AS 37.15.900 - 37.15.955.

29 **Sec. 37.15.955. Definitions.** In AS 37.15.900 - 37.15.955,

30 (1) "bond redemption fund" means the pension obligation bond
31 redemption fund established in AS 37.15.905;

1 (2) "bond resolution" means a resolution or resolutions adopted by the
2 committee under AS 37.15.915 authorizing the issuance of bonds;

3 (3) "bonds" means the pension obligation bonds authorized in
4 AS 37.15.900 - 37.15.955;

5 (4) "committee" means the state bond committee created in
6 AS 37.15.110 or any other committee, body, department, or officer of the state that
7 succeeds to the rights, powers, duties, and obligations of the state bond committee by
8 law;

9 (5) "costs of issuance and administration" means all costs associated
10 with issuance and administration of pension obligation bonds and refunding bonds,
11 including costs of bond printing, official statements, financial advisors, travel costs,
12 rating agencies, bond insurance, letters and lines of credit for credit enhancement,
13 underwriters, legal services, paying agents, bond registrars, bond and escrow trustees,
14 arbitrage rebate, and all other costs, including administrative costs, both direct and
15 indirect.

16 * **Sec. 9.** AS 37 is amended by adding a new chapter to read:

17 **Chapter 16. Alaska Pension Obligation Bond Corporation.**

18 **Sec. 37.16.010. Alaska Pension Obligation Bond Corporation.** There is
19 established the Alaska Pension Obligation Bond Corporation. The corporation is a
20 public corporation and government instrumentality in the Department of Revenue
21 managed by a board of directors. The purpose of the corporation is to finance
22 prepayment of all or a portion of a governmental employer's share of unfunded
23 accrued actuarial liability of retirement systems.

24 **Sec. 37.16.020. Board of directors.** The directors of the corporation are the
25 commissioner of commerce, community, and economic development, the
26 commissioner of administration, and the commissioner of revenue. If a director is
27 absent or otherwise unable to act, the director's designee in the department shall act as
28 a director of the corporation in the director's place.

29 **Sec. 37.16.030. Bond authorization.** (a) For purposes of financing
30 prepayment of all or a portion of a governmental employer's share of unfunded
31 accrued actuarial liability of retirement systems, including the costs of issuance and

1 administration, the issuance and sale of bonds by the corporation is authorized as
2 provided in this section and AS 37.16.040 - 37.16.900. The net proceeds of the sale of
3 the bonds remaining after payment of costs of issuance and administration shall be
4 transferred to the commissioner of administration for the account of the governmental
5 employer whose share of unfunded accrued actuarial liability is to be prepaid for
6 application to that liability. Accrued interest paid on the bonds shall be paid into the
7 reserve fund.

8 (b) The total unpaid principal amount of bonds, including refunding bonds,
9 but excluding refunded bonds, may not exceed \$5,000,000,000. The bonds do not
10 constitute a general obligation of the state. Authorization by the votes of the state or
11 the legislature is not required.

12 (c) The corporation may enter into agreements with other state agencies as
13 necessary or convenient to implement this section and AS 37.16.040 - 37.16.900.

14 (d) The corporation may contract for the services of underwriters, paying
15 agents, trustees, bond printers, rating agencies, bond insurance, credit enhancement
16 providers, accountants, financial advisors, and bond counsel, and other services as are
17 necessary to accomplish the bond issuance and sale.

18 **Sec. 37.16.040. Reserve fund.** (a) The corporation may establish and maintain
19 a special fund called the Alaska Pension Obligation Bond Corporation reserve fund in
20 which there shall be deposited or transferred

21 (1) all money appropriated by the legislature for the purpose of the
22 fund in accordance with the provisions of (g) of this section;

23 (2) all proceeds of bonds required to be deposited in the fund by terms
24 of a contract between the corporation and its bondholders or a resolution of the
25 corporation with respect to the proceeds of bonds;

26 (3) all other money appropriated by the legislature to the reserve fund;
27 and

28 (4) any other money or funds of the corporation that it decides to
29 deposit in the fund.

30 (b) Subject to the provisions of (h) of this section, money in the reserve fund
31 shall be held and applied solely to the payment of the interest on and principal of

1 bonds of the corporation as the interest and principal become due and payable to the
2 retirement of bonds, or to the payment or prepayment of a portion of the participating
3 governmental employer's share of the accrued actuarial liabilities of retirement
4 systems. Money may not be withdrawn if a withdrawal would reduce the amount in
5 the reserve fund to an amount less than the required debt service reserve except for
6 payment of interest then due and payable on bonds and the principal of bonds then
7 maturing and payable and for the retirement of bonds in accordance with the terms of
8 a contract between the corporation and its bondholders and for which payments of
9 other money of the corporation is not then available.

10 (c) Money in the reserve fund in excess of the required debt service reserve as
11 defined in (b) of this section, whether by reason of investment or otherwise, may be
12 withdrawn at any time by the corporation to pay or prepay a portion of participating
13 governmental employer's share of the accrued actuarial liabilities of retirement
14 systems or transferred to another fund or account of the corporation subject to the
15 provision of (h) of this section.

16 (d) Money in the reserve fund may be invested in the same manner and on the
17 same conditions as permitted for investment of funds belonging to the state or held in
18 the treasury under AS 37.10.070; however, the corporation may agree with the
19 bondholders to further limit these investments.

20 (e) For purposes of valuation, investments in the reserve fund shall be valued
21 at par or, if purchased at less than par, at cost unless otherwise provided by resolution
22 of the corporation. Valuation on a particular date shall include the amount of interest
23 then earned or accrued to that date on the money or investments in the reserve fund.

24 (f) Notwithstanding any other provision of AS 37.16.010 - 37.16.900, bonds
25 may not be issued by the corporation unless there is in the reserve fund the required
26 debt service reserve for all bonds then issued and outstanding and for the bonds to be
27 issued; however, the corporation may satisfy this requirement by depositing as much
28 of the proceeds of the bonds to be issued, upon their issuance, as is needed to meet the
29 required debt service reserve. The corporation may at any time issue its bonds or notes
30 for the purpose of increasing the amount in the reserve fund to the required debt
31 service reserve, or to meet whatever higher or additional reserve that may be fixed by

1 the corporation with respect to the fund.

2 (g) In order to assure the maintenance of the required debt service reserve in
3 the reserve fund, the legislature may appropriate annually to the corporation for
4 deposit in the fund the sum, certified by the chair of the corporation to the governor
5 and to the legislature, that is necessary to restore the fund to an amount equal to the
6 required debt service reserve. The chair annually, before January 30, shall make and
7 deliver to the governor and to the legislature a certificate stating the sum required to
8 restore the fund to that amount, and the certified sum may be appropriated and paid to
9 the corporation during the then current state fiscal year. Nothing in this subsection
10 creates a debt or liability of the state.

11 (h) All amounts received on account of money appropriated to the reserve
12 fund shall be held and applied in accordance with (b) of this section.

13 (i) All references to the reserve fund in this section include special accounts
14 within the reserve fund that may be created by the corporation to secure the payment
15 of particular bonds.

16 (j) The commissioner of revenue may, subject to appropriation, lend surplus
17 money in the general fund to the corporation for deposit to any account in the reserve
18 fund in an amount equal to the required debt service reserve. The loans shall be made
19 on the terms and conditions that may be agreed upon by the commissioner of revenue
20 and the corporation, including, without limitation, terms and conditions providing that
21 the loans need not be repaid until the obligations of the corporation secured and to be
22 secured by the account in the reserve fund are no longer outstanding.

23 (k) In this section, "required debt service reserve" means, as of the date of
24 computation, the amount required to be on deposit in the reserve fund as provided by
25 resolution of the corporation.

26 **Sec. 37.16.050. Bond terms.** (a) The bonds may be issued and sold at public
27 or negotiated sale in the manner, in the amounts or series, and at the time or times that
28 the corporation determines the bonds, or each series of them, shall be sold at the price
29 and upon the terms, conditions, and covenants set by the corporation after considering
30 market conditions. Interest rates may be fixed or variable.

31 (b) The bonds mature at the time or times fixed by the corporation. The bonds

1 may be subject to redemption before their fixed maturities, as determined by the
2 corporation, with or without a premium or premiums. The bonds may be in
3 denominations determined by the corporation; may be issued in fully or partially
4 registered form; must be payable as to principal and interest at the place or places
5 determined by the corporation; must be signed in the manner provided by the
6 corporation; and must be issued under and subject to the terms, conditions, covenants,
7 and protective features safeguarding payment of the bonds as found necessary by the
8 corporation.

9 (c) If the corporation finds it reasonably necessary, the corporation may select
10 a trustee or trustees for the holders of the bonds, or any series of them, for the
11 safeguarding and disbursement of any of the money in the bond reserve fund or for
12 duties with respect to the enforcement, authentication, delivery, payment, and
13 registration of the bonds as the corporation may determine. The corporation shall fix
14 the rights, duties, powers and obligations of the trustee or trustees.

15 (d) In its determination of all matters and questions relating to the issuance
16 and sale of the bonds and the fixing of their maturities, terms, conditions, and
17 covenants as provided in (a) of this section, the decisions of the corporation shall be
18 those that are reasonably necessary for the best interests of the state and its inhabitants
19 and that will accomplish the most advantageous sale of the bonds. Decisions of the
20 corporation, as expressed in a bond resolution, are final and are conclusively
21 considered to comply with the requirements of AS 37.16.010 - 37.16.900.

22 **Sec. 37.16.060. Bond resolution.** The corporation shall authorize the issuance
23 of bonds by adopting a resolution and shall prepare all other documents and
24 proceedings necessary for the issuance, sale, and delivery of the bonds or any part or
25 series of them. The bond resolution must fix the principal amount, denominations,
26 date, maturities, manner of sale, place or places of payment, rights of redemption, if
27 any, terms, form, conditions, and covenants of the bonds or each series of them

28 **Sec. 37.16.070. Enforcement by bond owner.** (a) The owner or owners of not
29 less than 10 percent of the aggregate principal amount of any series or issue of bonds
30 or the trustee for the owners of the bonds or any series of them may, by appropriate
31 proceedings in state court, require and compel the transfer, setting aside, and payment

1 of money and the enforcement of all of the terms, conditions, and covenants as
 2 required and provided in AS 37.16.010 - 37.16.900, as appropriate, and the bond
 3 resolution.

4 (b) A proceeding under (a) of this section may be commenced and conducted
 5 only in the Superior Court for the State of Alaska, First Judicial District at Juneau.

6 **Sec. 37.16.080. Purposes and sufficiency of revenue.** The proceeds of bonds
 7 may be used for the purposes described in AS 37.16.030(a), as appropriate. Bonds
 8 may not be issued unless the corporation first finds that the actuarially assumed rate of
 9 return on the funds managed by the Alaska Retirement Management Board is
 10 projected to exceed the true interest cost to be paid on the bonds by at least 1.5 percent
 11 annually.

12 **Sec. 37.16.090. Refunding.** (a) The corporation may refund the bonds or any
 13 part of them at or before their maturities or redemption dates by the issuance of
 14 refunding bonds of the corporation if, in the opinion of the corporation, refunding is
 15 advantageous to and in the best interest of the state and its inhabitants.

16 (b) The issuance of refunding bonds need not be authorized by the voters of
 17 the state or by an act of the legislature. The corporation shall adopt the resolution or
 18 resolutions and prepare all other documents and proceedings necessary for the
 19 issuance, exchange or sale, and delivery of the refunding bonds. All provisions of
 20 AS 37.16.010 - 37.16.900 are applicable to the refunding bonds and to the issuance,
 21 sale, or exchange of them, except as otherwise provided in this section.

22 (c) Refunding bonds may be issued in a principal amount sufficient to provide
 23 money for the advance or current refunding of all bonds to be refunded and interest on
 24 the refunded bonds and, in addition, for the payment of all costs of issuance and
 25 administration of the refunding bonds. These expenses also include the difference in
 26 amount between the par value of the refunding bonds and any amount less than par for
 27 which the refunding bonds are sold; the premium, if any, necessary to be paid in order
 28 to call or retire the outstanding bonds and the interests accruing on them to date of the
 29 call or retirement; and other of these costs. The corporation is authorized to incur
 30 expenses to carry out this section.

31 (d) The corporation may contract with a refunding trustee to hold the proceeds

1 of refunding bonds in trust until the proceeds, together with earnings on the proceeds,
2 are applied to pay the principal of premium, if any, and interest on the bonds to be
3 refunded. Until the refunding bond proceeds are applied, the proceeds may be invested
4 in direct obligations of, or obligations guaranteed by, the United States of an agency or
5 corporation of the United States whose obligations constitute direct obligations of, or
6 obligations guaranteed by the United States.

7 **Sec. 37.16.100. Bonds as legal investments.** The bonds are legal investments
8 for all banks, trust companies, savings banks, savings and loan associations, and other
9 persons carrying on a banking business, all insurance companies and other persons
10 carrying on an insurance business, and all executors, administrators, trustees, and other
11 fiduciaries. The bonds may be accepted as security for deposits of all money of the
12 state and its political subdivisions.

13 **Sec. 37.16.110. Debt service repayment contracts.** The corporation shall
14 enter into contracts with governmental employers for the purpose of recouping
15 amounts paid as debt service on bonds issued by the corporation for the benefit of
16 governmental employers. The corporation may pledge the revenue of the contracts as
17 security for the bonds issued by the corporation.

18 **Sec. 37.16.800. Statutory construction.** AS 37.16.010 - 37.16.900 shall be
19 liberally construed in order to carry out the purposes for which they were enacted.

20 **Sec. 37.16.810. Regulations.** The corporation may adopt regulations necessary
21 to implement the provisions of AS 37.16.010 - 37.16.900.

22 **Sec. 37.16.900. Definitions.** In AS 37.16.010 - 37.16.900,

23 (1) "bond resolution" means the resolution or resolutions adopted by
24 the corporation under AS 37.16.060 authorizing the issuance of bonds;

25 (2) "bonds" means the pensions obligation bonds authorized in
26 AS 37.16.010 - 37.16.900;

27 (3) "corporation" means the Alaska Pension Obligation Bond
28 Corporation created in AS 37.16.010;

29 (4) "costs of issuance and administration" means all costs associated
30 with issuance and administration of pension obligation bonds and refunding bonds,
31 including costs of bond printing, official statements, financial advisors, travel costs,

1 rating agencies, bond insurance, letters and lines of credit for credit enhancement,
2 underwriters, legal services, paying agents, bonds registrars, bond and escrow trustees,
3 arbitrage rebate, and all other costs, including administrative costs, both direct and
4 indirect;

5 (5) "reserve fund" means the Alaska Pension Obligation Bond
6 Corporation reserve fund established in AS 37.16.040.

7 * Sec. 10. AS 39.35.100(b)(3) is amended to read:

8 (3) A separate account for each employer shall be maintained. The
9 account shall be credited with contributions made by or on behalf of the employer.
10 Except as provided in AS 39.35.270(d), this [THIS] account shall be charged with
11 the employer's actuarial charge for pension, death benefits, and other benefits paid
12 under this plan to or on behalf of the employee of the employer. Except as provided
13 in AS 39.35.270(d), after [AFTER] an allowance for interest credited to employee
14 contribution accounts and employee savings accounts, the investment income of the
15 pension fund shall be allocated to the retirement reserve account and to each employer
16 asset share account according to the ratio that the average of the assets in the account
17 as of the beginning and as of the end of the fiscal year bears to the total of the average
18 balance of the retirement reserve account and all employer accounts.

19 * Sec. 11. AS 39.35.100(b)(4) is amended to read:

20 (4) An expense account shall be maintained for the plan. Except as
21 provided in AS 39.35.270(d), this [THIS] account shall be charged with all
22 disbursements representing administrative expenses incurred by the plan. At the end of
23 the year, the expense account shall be allocated to each employer in accordance with
24 (3) of this subsection. Expenditures from this account shall be included in the
25 governor's budget for each fiscal year and are subject to approval by the legislature.

26 * Sec. 12. AS 39.35.270 is amended by adding new subsections to read:

27 (d) All or a portion of the employer's share of any accrued actuarial liability to
28 the plan may be prepaid in a lump sum. The commissioner may, by regulation,
29 establish a minimum amount for the lump sum payment of a portion. The
30 commissioner shall charge to the employer appropriate and reasonable costs to the
31 plan attributable to a lump sum payment that are not greater than administrative costs

1 applied to other employer contributions. If a lump sum payment is made, the payment
2 shall be accounted for separately in accordance with regulations adopted by the
3 commissioner. The regulations must provide for crediting to each lump sum payment
4 account all earnings and losses received from investment of that payment. The lump
5 sum payment shall be used solely to offset contributions under this section required of
6 the employer that made the payment or on whose behalf the payment was made,
7 taking into account earnings and losses from its investment. A lump sum payment
8 made by or on behalf of an employer under this subsection, together with all earnings
9 and losses from investment of that payment, may not be considered in calculating that
10 employer's share of any discretionary payment authorized by the state that benefits
11 multiple employers.

12 (e) If all or a portion of the employer's share of any accrued actuarial liability
13 to the plan is prepaid in a lump sum under (d) of this section, the administrator shall
14 calculate a revised employer contribution rate for that employer in recognition of that
15 prepayment not more than 30 days following the prepayment.

16 * Sec. 13. AS 44.85.010 is amended to read:

17 **Sec. 44.85.010. Legislative policy.** (a) It is the policy of the state to

18 (1) [TO] foster and promote by all reasonable means the provision of
19 adequate capital markets and facilities for borrowing money by municipalities in the
20 state to finance capital improvements or for other authorized purposes, to assist these
21 municipalities in fulfilling their capital needs and requirements by use of borrowed
22 money within statutory interest rate or cost of borrowing limitations, to the greatest
23 extent possible to reduce costs of borrowed money to taxpayers and residents of the
24 state, and equally to encourage continued investor interest in the purchase of bonds or
25 notes of municipalities as sound and preferred securities for investment;

26 (2) [TO] encourage municipalities to continue their independent
27 undertakings and financing of capital improvements and other authorized purposes
28 and to assist them by making capital funds available at reduced interest costs for
29 orderly financing of capital improvements and other purposes especially during
30 periods of restricted credit or money supply, particularly for those municipalities not
31 otherwise able to borrow for capital needs;

1 (3) [TO] assist municipalities to provide for adequate insurance
2 coverage by authorizing the Alaska Municipal Bond Bank Authority to issue
3 negotiable or nonnegotiable revenue bonds, notes, or certificates of participation either
4 directly or through an entity it may create for the purpose of providing a self-insurance
5 program for municipalities or municipal joint insurance arrangements organized under
6 AS 21.76;

7 (4) assist governmental employers to prepay all or a portion of
8 their share of unfunded accrued actuarial liabilities of retirement systems in an
9 effort to reduce their costs of satisfying their contractual obligations to provide
10 retirement and other benefits to public employees through the issuance of bonds,
11 notes, commercial paper, or other obligations by the bond bank authority or by a
12 subsidiary corporation created by the bond bank authority under AS 44.85.085.

13 (b) The legislature further declares that

14 (1) the exercise of the powers of the state in the interest of its
15 municipalities and in the interest of public employees of the state and of its
16 municipalities is required to further and implement the policies declared in (a) of this
17 section by authorizing the creation of a state bond bank authority as a body corporate
18 and politic that will have full powers to borrow money and to issue its bonds and notes
19 to make capital funds available for borrowing by municipalities and for borrowing
20 by or on behalf of governmental employers, by authorizing governmental
21 employers to contract with the bond bank authority or with a subsidiary created
22 under AS 44.85.085 for the purpose of reducing future costs of providing
23 retirement and other benefits to employees, and by granting broad powers to the
24 bond bank authority to carry out the declared policies, which are in the public interest
25 of the state and its taxpayers and residents;

26 (2) state funds should be applied or authorized to be paid to a state
27 bond bank authority only to provide adequate assurance and security to the holders of
28 the bonds or notes of the bond bank authority;

29 (3) the bond bank authority should conduct its operations to provide
30 the lowest rates in terms of borrowing to municipalities as is consistent with a self-
31 supporting operation with no expectation of subsidization with state funds; the

1 legislature does not intend that the bond bank authority be utilized as a means to
 2 finance municipalities beyond their capability to meet repayment schedules and debt
 3 service requirements of bonds or notes;

4 (4) the bond bank authority or its subsidiary should conduct its
 5 operations to provide the lowest rates in terms of borrowing to governmental
 6 employers under AS 44.85.085 and 44.85.086 as is consistent with a self-
 7 supporting operation with no expectation of subsidization with state funds; the
 8 legislature does not intend that the bond bank authority or its subsidiary be
 9 utilized as a means to finance governmental employers under AS 44.85.085 and
 10 44.85.086 beyond their capability to meet repayment schedules and debt service
 11 requirements of bonds, notes, commercial paper, or other obligations to the bond
 12 bank authority or its subsidiary.

13 * Sec. 14. AS 44.85.080 is amended to read:

14 Sec. 44.85.080. Powers of bond bank authority. The bond bank authority
 15 may

16 (1) sue and be sued;

17 (2) adopt and alter an official seal;

18 (3) make and enforce bylaws and regulations for the conduct of its
 19 business and for the use of its services and facilities;

20 (4) maintain an office at any place in the state;

21 (5) acquire, hold, use, and dispose of its income, revenues, funds, and
 22 money;

23 (6) acquire, rent, lease, hold, use, and dispose of other personal
 24 property for its purposes;

25 (7) subject to AS 44.85.100(b), borrow money and issue its negotiable
 26 bonds or notes and provide for and secure their payment, provide for the rights of their
 27 holders, and purchase, hold, and dispose of any of its bonds or notes;

28 (8) fix and revise from time to time and charge and collect fees and
 29 charges for the use of its services or facilities;

30 (9) accept gifts or grants from the United States, or from any
 31 governmental unit or person, firm, or corporation, carry out the terms or provisions or

1 make agreements with respect to the gifts or grants, and do all things necessary,
2 useful, desirable, or convenient in connection with procuring, accepting, or disposing
3 of the gifts or grants;

4 (10) do anything authorized by this chapter, through its officers,
5 agents, or employees or by contracts with a person;

6 (11) make, enter into, and enforce all contracts necessary, convenient,
7 or desirable for the purposes of the bond bank authority or pertaining to a loan to a
8 political subdivision, a purchase or sale of municipal bonds or other investments, or
9 the performance of its duties and execution of any of its powers under this chapter;

10 (12) purchase or hold municipal bonds at prices and in a manner the
11 bond bank authority considers advisable, and sell municipal bonds acquired or held by
12 it at prices without relation to cost and in a manner the bond bank authority considers
13 advisable;

14 (13) invest funds or money of the bond bank authority not required at
15 the time of investment for loan to political subdivisions for the purchase of municipal
16 bonds, in the same manner as permitted for investment of funds belonging to the state,
17 except as otherwise provided in this chapter;

18 (14) prescribe the form of application or procedure required of a
19 political subdivision for a loan or purchase of its municipal bonds, fix the terms and
20 conditions of the loan or purchase, and enter into agreements with political
21 subdivisions with respect to loans or purchases;

22 (15) render services to a political subdivision in connection with a
23 public or private sale of its municipal bonds, including advisory and other services,
24 and charge for services rendered;

25 (16) charge for its costs and services in review or consideration of a
26 proposed loan to a political subdivision or purchase by the bond bank authority of
27 municipal bonds of the political subdivision, whether or not the loan is made or the
28 municipal bonds purchased;

29 (17) fix and establish terms and provisions with respect to a purchase
30 of municipal bonds by the bond bank authority, including date and maturities of the
31 bonds, provisions as to redemption or payment before maturity, and any other matters

1 that [WHICH] in connection with the purchase are necessary, desirable, or advisable
2 in the judgment of the bond bank authority;

3 (18) procure insurance against any losses in connection with its
4 property, operations, or assets in amounts and from insurers as it considers desirable;

5 (19) to the extent permitted under its contracts with the holders of
6 bonds or notes of the bond bank authority, consent to modification of the rate of
7 interest, time and payment of installment of principal or interest, security or any other
8 term of a bond or note, contract or agreement of any kind to which the bond bank
9 authority is a party;

10 (20) by regulation, create a new entity or new entities for the purpose
11 of issuing negotiable or nonnegotiable revenue bonds, notes, or certificates of
12 participation to finance a self-insurance program for municipalities or municipal joint
13 insurance arrangements organized under AS 21.76 or to provide assistance to
14 governmental employers under AS 44.85.085(a); the powers, duties, and
15 membership of the new entity or entities shall be limited to the powers, duties, and
16 membership of the authority and stated in the regulation; the new entity or entities
17 shall each be a public corporation and an instrumentality of the state with the same
18 legal existence and continuing succession as the bond bank authority; and

19 (21) do all acts and things necessary, convenient, or desirable to carry
20 out the powers expressly granted or necessarily implied in this chapter.

21 * Sec. 15. AS 44.85 is amended by adding new sections to read:

22 **Sec. 44.85.085. Creation of subsidiary corporation.** (a) The bond bank
23 authority may create one or more subsidiary corporations for the following purposes:

24 (1) providing financial and other assistance to governmental employers
25 to enable the governmental employers to reduce their costs of providing retirement
26 and other benefits to their employees by prepaying all or a portion of their shares of
27 the unfunded accrued actuarial liabilities of retirement systems;

28 (2) receiving payments and providing servicing for payments to or
29 from participating governmental employers; and

30 (3) performing other duties and providing other services as the
31 subsidiary corporation considers necessary or desirable to further the purposes set out

1 in (1) and (2) of this subsection.

2 (b) The bond bank authority may incorporate under AS 10.20.146 - 10.20.166
3 a subsidiary corporation created under (a) of this section. The bond bank authority
4 may transfer assets of the bond bank authority to the subsidiary corporation and may
5 agree to secure bonds, notes, commercial paper, or other obligations of the subsidiary
6 corporation with a reserve fund established under AS 44.85.270.

7 (c) A subsidiary corporation created under (a) of this section may borrow
8 money and issue bonds, notes, commercial paper, or other obligations as evidence of
9 that borrowing and may have all the powers of the bond bank authority that the bond
10 bank authority grants to it. The provisions of AS 44.85.130 - 44.85.170 and 44.85.270
11 - 44.85.390 apply to the subsidiary corporation and to bonds, notes, commercial paper,
12 or other obligations issued by the subsidiary corporation. Unless otherwise provided
13 by the bond bank authority, the debts, liabilities, and obligations of the subsidiary
14 corporation are not the debts, liabilities, or obligations of the bond bank authority.

15 (d) The staff of the bond bank authority serves as staff of a subsidiary
16 corporation created under (a) of this section. The bond bank authority shall determine
17 the membership or the process for selecting the membership of the board of directors
18 of the subsidiary corporation. The bond bank authority may permit some or all of its
19 directors to serve on the board of directors of the subsidiary corporation.

20 **Sec. 44.85.086. Powers of subsidiary corporation.** A subsidiary corporation
21 created under AS 44.85.085 has the following powers in addition those granted to it
22 under AS 44.85.085(c):

23 (1) to make loans to and enter into contracts with governmental
24 employers;

25 (2) to incur debt in furtherance of its purposes in the form of bonds,
26 notes, commercial paper, or other obligations as the subsidiary corporation considers
27 appropriate;

28 (3) to secure its debt with a pledge of any assets that are available to
29 the subsidiary corporation for the purpose, including identified revenue and
30 contractual payments from participating governmental employers, and the general
31 assets and revenue of the subsidiary corporation; and

1 (4) to enter into contracts with underwriters, bond counsel, financial
2 advisors, accountants, actuaries, and other contractors to provide assistance as the
3 subsidiary corporation considers desirable to accomplish its purposes.

4 * Sec. 16. AS 44.85.100(b) is amended to read:

5 (b) The bond bank authority shall include in the report required by (a) of this
6 section an estimate of the amount of revenue bonds of the bond bank authority to be
7 issued during the fiscal year following the fiscal year in which the report is submitted.
8 Other than refunding bonds and other than bonds, notes, commercial paper, or
9 other obligations issued under AS 44.85.086 and 44.85.180(a)(5), the [THE] bond
10 bank authority may not issue revenue bonds [, OTHER THAN REFUNDING
11 BONDS,] in excess of \$75,000,000 during any fiscal year beginning after June 30,
12 1981, unless the legislature, by law, approves the estimate required by this subsection
13 for that fiscal year.

14 * Sec. 17. AS 44.85.180(a) is amended to read:

15 (a) Subject to AS 44.85.100(b), the bond bank authority may issue its bonds or
16 notes in principal amounts that it considers necessary to provide funds for any
17 purposes under this chapter, including

18 (1) the purchase of municipal bonds;

19 (2) the making of loans through the purchase of municipal bonds,
20 notes, or certificates of participation secured by an agreement between the bond bank
21 authority and a municipality or a municipal joint insurance arrangement organized
22 under AS 21.76;

23 (3) the payment, funding, or refunding of the principal of, or interest or
24 redemption premiums on, bonds or notes issued by it whether the bonds or notes or
25 interest to be funded or refunded have or have not become due;

26 (4) the establishment or increase of reserves to secure or to pay bonds
27 or notes or interest on bonds or notes and all other costs or expenses of the bond bank
28 authority incident to and necessary or convenient to carry out its corporate purposes
29 and powers;

30 (5) assisting governmental employers to prepay all or a portion of
31 their share of the unfunded accrued actuarial liabilities of retirement systems,

1 with security as the bond bank authority considers reasonable.

2 * Sec. 18. AS 44.85.180(c) is amended to read:

3 (c) Notwithstanding the provisions of (a) and (b) of this section, the total
4 amount of bond bank authority bonds and notes outstanding at any one time [,
5 EXCEPT BONDS OR NOTES ISSUED TO FUND OR REFUND BONDS OR
6 NOTES,] may not exceed \$750,000,000. This subsection does not apply to (1)
7 bonds or notes issued to fund or refund bonds or notes; (2) bonds, notes,
8 commercial paper, and other obligations issued under AS 44.85.086 or
9 44.85.180(a)(5).

10 * Sec. 19. AS 44.85.410 is amended by adding a new paragraph to read:

11 (8) "governmental employer" means the State of Alaska or a
12 municipality or other state or municipal governmental entity within the state, including
13 an agency, instrumentality, district, school district, public corporation, department,
14 division, or other subdivision of the state or of a municipality, in its capacity as an
15 employer.

16 * Sec. 20. This Act takes effect immediately under AS 01.10.070(c).

Representative Mike Hawker

Alaska State Legislature



House Bill 13 Sponsor Statement

Short Title: Retirement System Liability/Bonds

HB 13 provides governmental employers the opportunity to utilize a financial mechanism generally referred to as a "Pension Obligation Bond" (POB) to help reduce the ultimate cost of satisfying the unfunded accrued actuarial liabilities of their retirement systems. A POB is essentially a legal arbitrage transaction where money is borrowed at a lower rate of interest than the money earns when invested by the retirement system.

HB 13 clarifies the ability of municipal entities to include POBs in their strategy to reduce the cost of meeting unfunded pension liabilities and expands the authority of the Alaska Municipal Bond Bank Authority, the Alaska Housing Finance Corporation, and the state bond committee to support governmental employers seeking assistance engaging in such transactions. HB 13 also creates the Alaska Pension Obligation Bond Corporation. The authority granted in this legislation will allow for the greatest flexibility in creating transactions to fit the needs of public employers.

This bill does not authorize any debt instruments to be issued. Separate specific action would be required to initiate any transaction under the authority provided by HB 13.

Session:

State Capitol
Juneau, AK 99801
907 465-4949 direct
800 478-4950 toll free
907 465-4979 fax

Interim:

716 W 4th Avenue
Anchorage, AK 99501
907 269-0244 office
907 269-0248 fax

Member:

House Finance Committee
Legislative Budget
& Audit Committee

House District 32:

Eagle River
Anchorage
Rainbow
Indian
Bird
Girdwood
Portage
Whittier
Sunrise
Hope



25th Alaska State Legislature House Special Committee on Ways & Means

Changes between HB 13 and CS HB 13 (W&M)

Chair:

Rep. Mike Hawker
Capitol Room 502
465-4949

Vice-Chair:

Rep. Anna Fairclough
Capitol Room 411
465-3777

Members:

Rep. Bob Roses
Capitol Room 416
465-4939

Rep. Paul Seaton
Capitol Room 102
465-2689

Rep. Peggy Wilson
Capitol Room 403
465-3824

Rep. Sharon Cissna
Capitol Room 420
465-3875

Rep. Max Gruenberg
Capitol Room 110
465-4940

Committee Aide:

Juli Lucky
465-6587 direct
465-4979 fax

The major changes between HB 13 and CS HB 13 work draft version E are the requirement for an employer's contribution rate to be recalculated within 180 days of a lump sum payment authorized under this bill, the authorization for the Alaska Housing Finance Corporation and the state bond committee to participate in the sale of Pension Obligation Bonds, and the creation of the Alaska Pension Obligation Bond Corporation.

- Added new sections to require the plan administrator to recalculate the employer's contribution rate within 180 days of a lump sum payment to reduce their unfunded accrued actuarial liability (page 2, lines 27-28 and page 17, line 31 – page 18, line 4).
- Authorized the Alaska Housing Finance Corporation to create a subsidiary corporation to assist in the financing of Pension Obligation Bonds (new sections 2-5).
- Authorized the state bond committee to assist in the financing of Pension Obligation Bonds and set guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds (new Section 7).
- Created the Alaska Pension Obligation Bond Corporation to assist in the financing of Pension Obligation Bonds, defined its organization and structure, and set guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds (new section 8).
- Necessary title and conforming amendments to accommodate new language (page 1, lines 2-4 and lines 5-7; page 2, lines 5-7; page 4, lines 18-20; and page 5, lines 6-8).

CS House Bill 13
Work Draft Version E
Sectional Analysis

Prepared by Representative Mike Hawke's Office

- Section 1:** Allows a Teacher's Retirement System (TRS) employer to make a lump sum payment to prepay all or a part its share of the unfunded accrued actuarial pension liability (UAAL); allows the commissioner to accept a lump sum payment that is less than the full amount; allows administrative fees to be charged; outlines how the lump sum payment and earnings or losses will be credited; and holds an employer who prepays its liability harmless if there are future state discretionary payments that benefit multiple employers. Requires the administrator of the TRS plan to recalculate the employer contribution rate within 180 days of the lump sum payment.
- Sections 2 - 5:** These sections allow the Alaska Housing Finance Corporation (AHFC) to create a subsidiary to aid an employer in the financing of a prepayment of all or a portion of that employer's UAAL.
- Section 6:** Outlines how municipalities can join together to issue debt obligations and allows funds diversion agreements between the municipalities and state agencies.
- Section 7:** Adds Article 8 to the State Bonding Act, which authorizes the state bond committee to issue Pension Obligation Bonds (POBs) and provides guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds.
- Section 8:** Creates the Alaska Pension Obligation Bond Corporation, which is authorized to issue POBs. Provides guidelines and requirements for bond issuance, sale, structure, repayment and the investment and accounting of bond and investment proceeds.
- Sections 9 - 10:** Adds facilitating language to two sections of the accounting statute for the Public Employees Retirement System (PERS) to accommodate lump sum payments.
- Section 11:** Allows a PERS employer to make a lump sum payment to prepay all or a part its share of the accrued actuarial pension liability; allows the commissioner to accept a lump sum payment that is less than the full amount; allows administrative fees to be charged; outlines how the lump sum payment and earnings or losses will be credited; and holds an employer who prepays its liability harmless if there are future state discretionary payments that benefit multiple employers. Requires the administrator of the PERS plan to recalculate the employer contribution rate within 180 days of the lump sum prepayment.
- Section 12:** Adds to the statutory policies established for the Municipal Bond Bank Authority. Provides a directive to assist governmental employers to meet their unfunded retirement system obligations by issuing POBs on their behalf. Specifies that the bond bank should provide the lowest rates possible without subsidizing the employers beyond their means.
- Sections 13 - 14:** These sections allow the Municipal Bond Bank to create a subsidiary to aid an employer in the financing of a prepayment of all or a portion of that employer's UAAL.

- Section 15:** Exempts "Pension Obligation Bonds" from the current limit for revenue bonds that the Municipal Bond Bank may issue each year.
- Section 16:** Authorizes the Municipal Bond Bank to issue "Pension Obligation Bonds."
- Section 17:** Exempts "Pension Obligation Bonds" from the current limit for total revenue bonds and notes that the Municipal Bond Bank may have outstanding at any time.
- Section 18:** Adds a definition for "governmental employer" to the definitions section for the Municipal Bond Bank.
- Section 19:** Immediate effective date.



Pension Obligation Bonds

March 21, 2007

Department of Revenue



Overview of Pension Obligation Bonds (POBs)



Pension Obligation Bonds (POBs)

- Pension Obligation Bonds are bonds issued by a state or local government to pay its obligation to the pension system in which its employees are members.
- POBs have been an increasingly popular and successful way for state and local governments to accomplish financial and other objectives.
- According to Thomson Financial, during the past decade there have been 340 POB issues by state and local government issuers in at least 26 states.



Why Should We Consider Issuing POBs?

- Interest rate savings – the interest rate of POBs issued in the near future will be lower than 8.25% charged by the pension system.
- Arbitrage – the actual investment return of pension asset exceeds the POB cost.
- POBs are not generally viewed as adding to the debt burden of the state or local government issuer because they replace existing pension obligations.

Alaska Pension Bill/Unfunded Accrued Actuarial Liability (UAAL) in 2006

Total \$8.6 Billion:

\$5.5 Billion PERS

\$3.1 Billion TRS



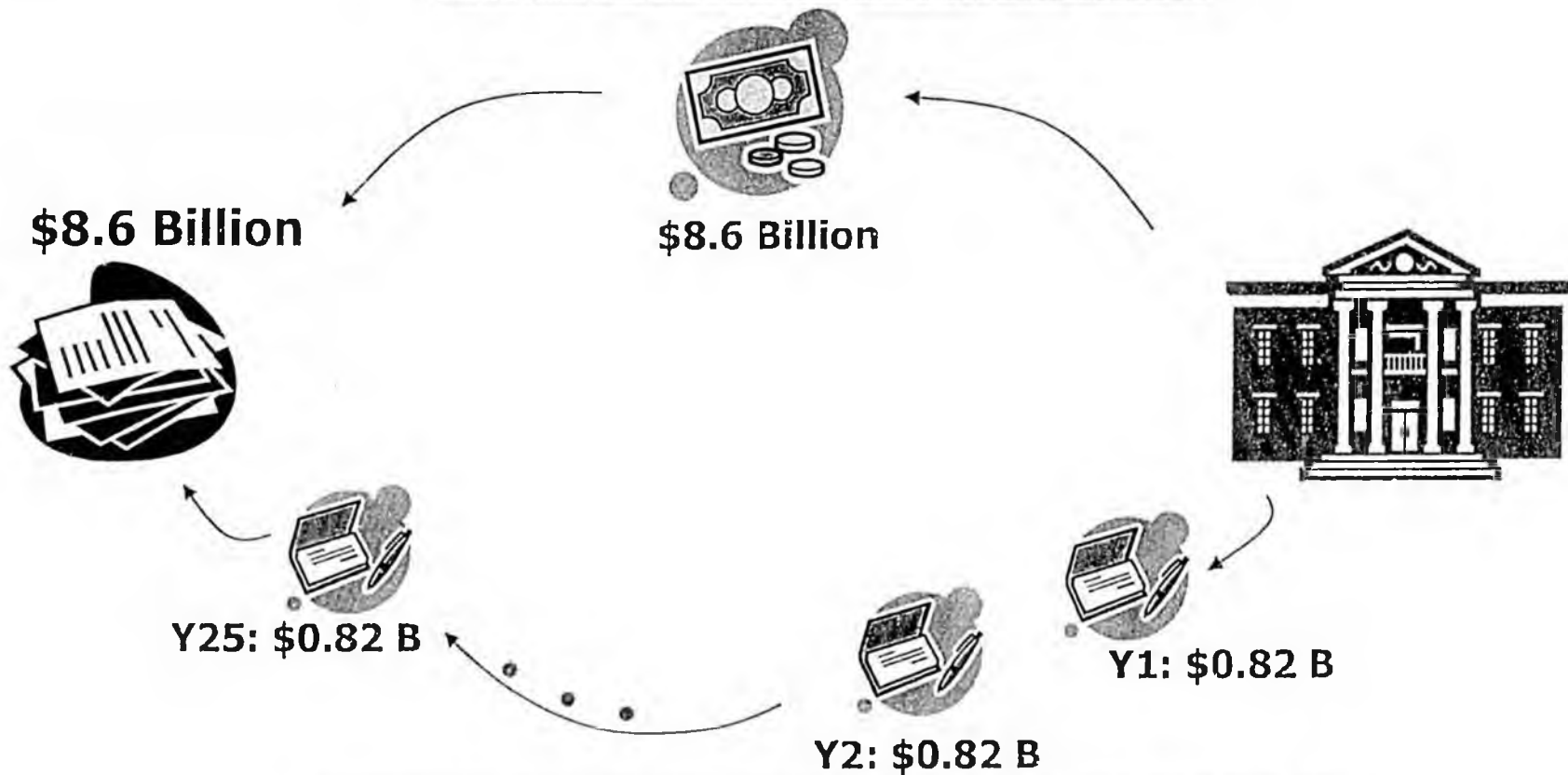
AK Pension System



State & Local Governments

Paying the Bill/UAAL

Option A: Pay the total with Cash



Option B: A "loan" of 25 years at 8.25% cost



Interest Rate Savings



Interest Rate Savings

Comparing the amortization of \$1 billion debt at 8.25% cost to \$1 billion debt at 5.75% over 25 years:

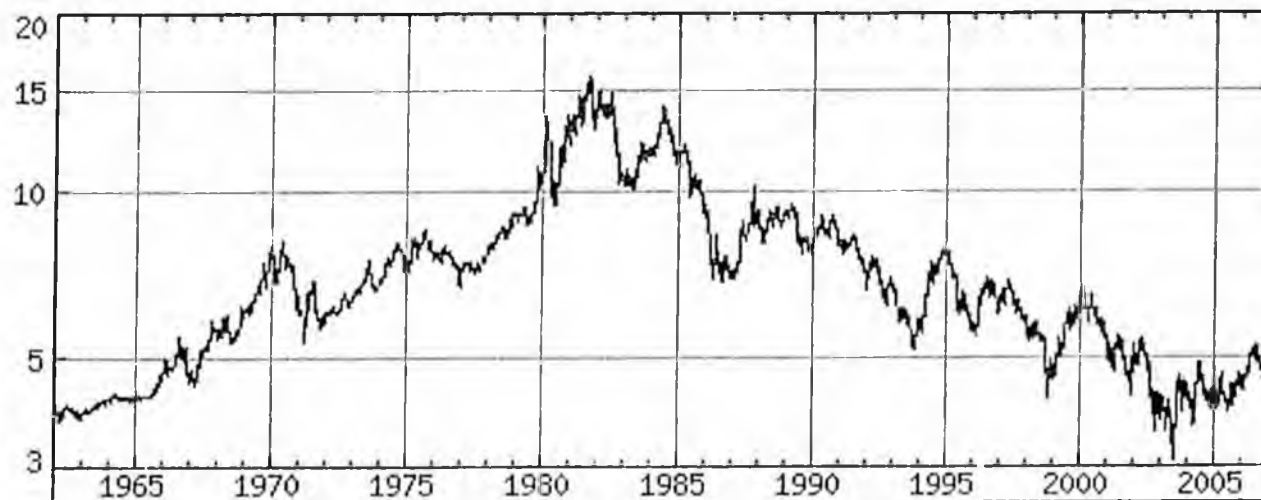
- Saving on interest cost is 2.5%;
- Saving on annual debt payment is \$19 million;
- NPV of savings on annual debt payment over 25 years is \$272 million discounted at 5%.

	Amount (\$Billion)	Interest Cost	Annual P&I Payment (\$Million)
\$	1	8.25%	\$ 96
\$	1	5.75%	\$ 76
Savings		2.50%	\$ 19
NPV of Cumulative Savings @ 5%			\$ 272

Interest Rate History

- 10-Year Treasury yield is 4.52% as of March 14, 2007. This rate is extraordinarily attractive when viewed in a historical context.

10-Year Treasury Yields

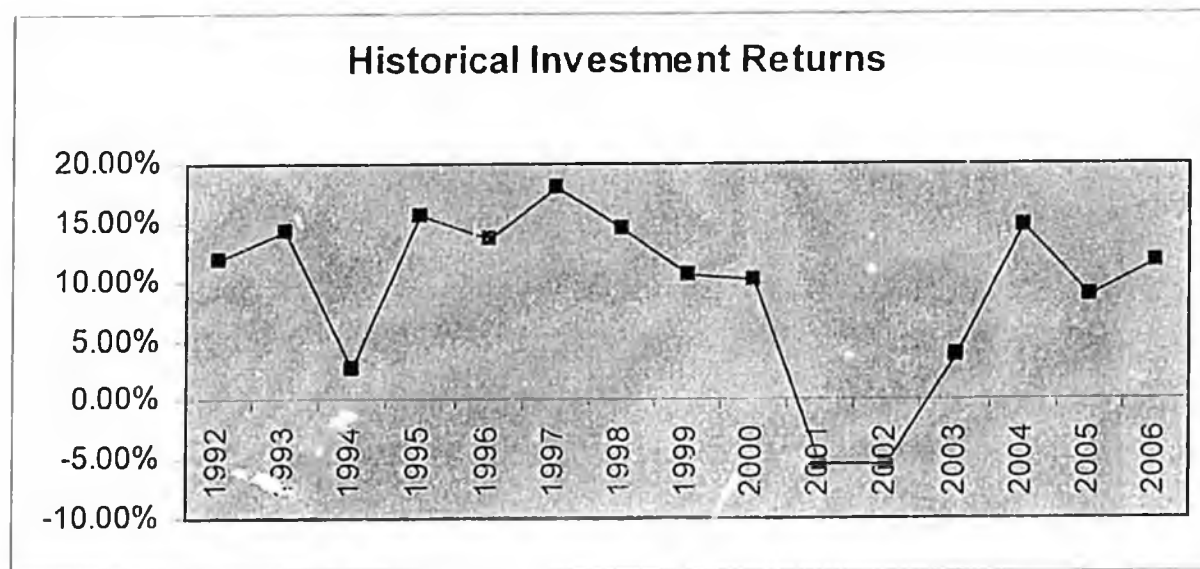




Arbitrage

Historical Investment Returns of State Pension Plans (PERS)

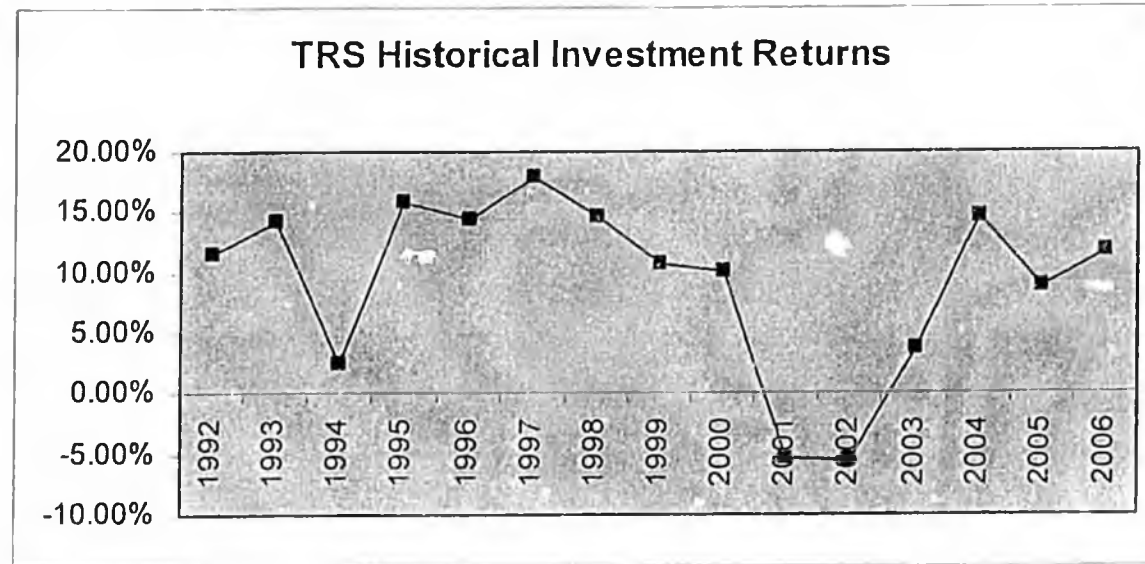
FY	ROR
2006	11.69%
2005	8.86%
2004	14.73%
2003	3.82%
2002	-5.40%
2001	-5.30%
2000	10.12%
1999	10.65%
1998	14.62%
1997	18.07%
1996	13.70%
1995	15.56%
1994	2.66%
1993	14.25%
1992	11.80%



- The average return from 1992 to 2006 is 9.09%.
- Standard Deviation is 7.25%.

Historical Investment Returns of State Pension Plans (TRS)

FY	ROR
2006	11.72%
2005	8.90%
2004	14.75%
2003	3.81%
2002	-5.41%
2001	-5.36%
2000	10.19%
1999	10.73%
1998	14.73%
1997	18.00%
1996	14.35%
1995	15.89%
1994	2.61%
1993	14.16%
1992	11.58%



- The average return from 1992 to 2006 is 9.14%.
- Standard Deviation is 7.31%.



Long Term Target Asset Allocation

Asset Class	Allocation	Range
Domestic Large Capitalization	30%	± 3%
Domestic Small Capitalization	6%	± 3%
International Equity	14%	± 3%
Emerging Markets Equity	2%	± 2%
Private Equity	7%	± 5%
Domestic Fixed-Income	20%	± 3%
High Yield	2%	± 2%
International Fixed-Income	2%	± 2%
Real Estate	10%	± 4%
Absolute Return	4%	± 4%
Other	3%	± 3%
Cash	0%	± 3%

Median Return	8.05%
Standard Deviation	12.27%

Source: Callan Associates, Inc.



Credit Neutrality



Credit Rating Consideration

- Credit Neutral – debt obligation is already recognized and POBs are not considered new debt.
- “Moody’s believes the issuance of POBs is one effective way of addressing an unfunded liability.”
- “Standard & Poor’s has viewed POBs as a strategy for savings on carrying charges as long as the transaction are structured conservatively and the assumptions were reasonable and attainable.”



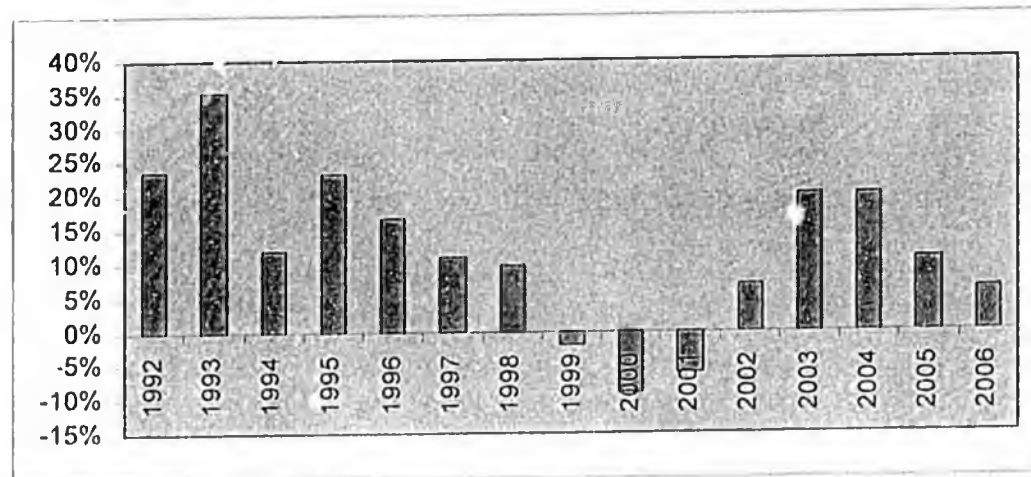
Risks



Investment Risk (PERS)

FY	ROR	Estimated Cost of Borrowing	Estimated Cumulative Net Return to 2006
2006	11.69%	5.55%	6.14%
2005	8.86%	5.04%	10.47%
2004	14.73%	5.02%	20.22%
2003	3.82%	4.76%	20.06%
2002	-5.40%	5.36%	6.90%
2001	-5.30%	5.77%	-6.22%
2000	10.12%	6.78%	-8.94%
1999	10.65%	6.40%	-2.03%
1998	14.62%	6.01%	9.70%
1997	18.07%	7.10%	10.86%
1996	13.70%	7.19%	16.47%
1995	15.56%	7.32%	23.28%
1994	2.66%	7.84%	11.86%
1993	14.25%	6.62%	35.35%
1992	11.80%	7.76%	23.43%

Estimated Cumulative Net Return to 2006 (PERS)

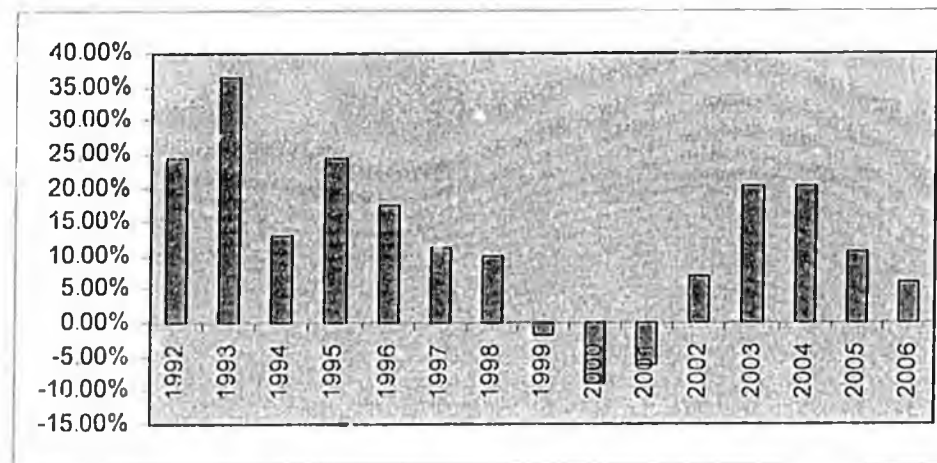


- Based on PERS actual investment history, we can see what the cumulative net return to 2006 might have been if POBs had been issued in any given year.
- For 12 out of 15 years the issuance of POBs would have resulted in a gain to the pension system.

Investment Risk (TRS)

FY	ROR	Estimated Cost of Borrowing	Estimated Cumulative Net Return to 2006
2006	11.72%	5.55%	6.17%
2005	8.90%	5.04%	10.54%
2004	14.75%	5.02%	20.31%
2003	3.81%	4.76%	20.14%
2002	-5.41%	5.36%	6.97%
2001	-5.36%	5.77%	-6.21%
2000	10.19%	6.78%	-8.86%
1999	10.73%	6.40%	-1.87%
1998	14.73%	6.01%	9.97%
1997	18.00%	7.10%	11.06%
1996	14.35%	7.19%	17.32%
1995	15.89%	7.32%	24.46%
1994	2.61%	7.84%	12.99%
1993	14.16%	6.62%	36.39%
1992	11.58%	7.76%	24.25%

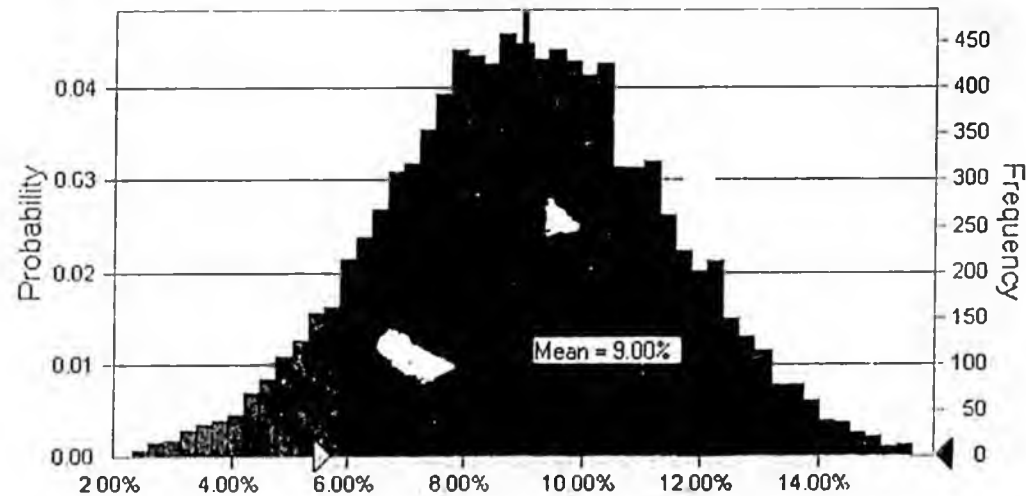
Estimated Cumulative Net Return to 2006 (TRS)



- Based on TRS actual investment history, we can see what the cumulative net return to 2006 might have been if POBs had been issued in any given year.
- For 12 out of 15 years the issuance of POBs would have resulted in a gain to the pension system.

Investment Return Forecast

With an asset mix of 70% S&P 500 Equity and 30% Government/Credit Bonds, the average return over 25 years is 9%.



Monte Carlo Simulation

- 10,000 iteration
- Annualized Average Return: 9%
- Probability of outperforming 5.75%: 91.45%



Types of POBs



Security

- **General obligation bonds**

Bonds that satisfy any constitutional debt limitation and are backed by the full faith and credit and taxing power of the issuing state and local government.

- **Obligations imposed by law**

Obligations imposed by the state or local government by the constitution or by statute or by court judgment as distinguished from a voluntary exercise of the borrowing power by the state or local government.

- **Annual appropriation bonds**

Bonds that are not considered debt subject to a constitutional debt limitation because the state and local government issuer has no legal obligation to pay them and payment is therefore subject to annual appropriation of funds for that purpose at the discretion of the legislature or governing body of the state or local government issuer.

Taxable POB Bond Alternatives (1 of 2)

Taxable Product Alternatives			
Product	Investors	Advantages	Disadvantages
Current Interest Bonds (CIBS)	Domestic Institutions; European Banks	Low-Cost Financing; No Basis Risk	Typically Non-Callable or Issued with a Make-Whole Call on Term Bonds; Call Option Expensive
Zero Coupon Bonds (CABs)	Domestic Institutions; European Banks	Defers Debt Service	More Expensive than CIBs; Noncallable
Put Bonds	Domestic Institutions; Corporations	Benefit of Upward Sloping Yield Curve Versus Conventional Fixed-Rate Bonds	Interest Rate Risk
Quarterly Unsecured Interest Bonds (QUIBs)	Domestic Retail	Provides Most Efficient 5-Year Call Option	Slightly Higher Yield; 3% Issuance Cost
Floating Rate Notes (FRNs)	European Banks	Fixed Spread to LIBOR; Historically Least Costly Form of Financing; Provides Quarterly Call Options; No Ongoing Fees	Interest Rate Risk
Variable Rate Demand Bonds	Money Market Funds	Historically Least Costly Form of Financing; Continuously Callable at Par	Interest Rate Risk; Facility Renewal Risk
Auction Rate Notes	Corporations; High Net Worth Retail	Historically Least Costly Form of Financing; Continuously Callable at Par	Interest Rate Risk

Taxable POB Bond Alternatives (2 of 2)

	Variable Rate Demand Bonds	Auction Rate Notes	Floating Rate Notes (Private Placement)
Prepayment	Yes	Yes	Yes
Interest Rate Reset	Weekly	Varies	Varies
Liquidity Facility Required	Yes	No	No
Rating Required	Yes	Yes	No
Legal Documentation	Substantial	Substantial	Simplified
Concerns	Failed Remarketing	Failed Auction	Short-term interest rates only
Investor Base	Money-market funds	Retail investors	European banks
Term Out Provisions	Yes	No	No



Potential Saving



POBs and Cash Infusion

Pay partial UAAL off with cash and borrow partial at 5.75% by issuance of Pension Obligation Bonds (POBs).

Implications

- Immediate reduction of the UAAL;
- Increase in the Funded Ratio;
- Reduction of employer past service contribution rate.

Case Study (PERS)

Employer Contribution Rates
POBs (in billions)

Cash (in billions)	POBs (in billions)							
	\$ -	\$ 0.5	\$ 1.5	\$ 2.5	\$ 3.5	\$ 4.5	\$ 5.5	
	0%	9%	27%	45%	64%	82%	100%	
\$ -	44.49%	43.91%	42.76%	41.61%	40.46%	39.31%	38.15%	
\$ 0.5	41.64%	41.06%	39.91%	38.76%	37.60%	36.45%		
\$ 1.5	35.93%	35.35%	34.20%	33.05%	31.90%			
\$ 2.5	30.22%	29.64%	28.49%	27.34%				
\$ 3.5	24.51%	23.94%	22.78%					
\$ 4.5	18.80%	18.23%						
\$ 5.5	13.09%							

Savings on Annual Contribution Amount (in millions)
POBs (in billions)

Cash (in billions)	POBs (in billions)							
	\$ -	\$ 0.5	\$ 1.5	\$ 2.5	\$ 3.5	\$ 4.5	\$ 5.5	
	0%	9%	27%	45%	64%	82%	100%	
\$ -	\$0.00	\$9.65	\$28.96	\$48.27	\$67.58	\$86.89	\$106.20	
\$ 0.5	\$47.84	\$57.50	\$76.81	\$96.12	\$115.43	\$134.73		
\$ 1.5	\$143.53	\$153.19	\$172.49	\$191.80	\$211.11			
\$ 2.5	\$239.22	\$248.87	\$268.18	\$287.49				
\$ 3.5	\$334.91	\$344.56	\$363.87					
\$ 4.5	\$430.59	\$440.25						
\$ 5.5	\$526.28							

Savings on Employer Contribution Rates
POBs (in billions)

Cash (in billions)	POBs (in billions)							
	\$ -	\$ 0.5	\$ 1.5	\$ 2.5	\$ 3.5	\$ 4.5	\$ 5.5	
	0%	9%	27%	45%	64%	82%	100%	
\$ -	0.00%	0.58%	1.73%	2.88%	4.03%	5.18%	6.34%	
\$ 0.5	2.85%	3.43%	4.58%	5.73%	6.89%	8.04%		
\$ 1.5	8.56%	9.14%	10.29%	11.44%	12.59%			
\$ 2.5	14.27%	14.85%	16.00%	17.15%				
\$ 3.5	19.98%	20.55%	21.71%					
\$ 4.5	25.69%	26.26%						
\$ 5.5	31.40%							

NPV of Savings on 25-year Contribution Amount (in millions)
POBs (in billions)

Cash (in billions)	POBs (in billions)							
	\$ -	\$ 0.5	\$ 1.5	\$ 2.5	\$ 3.5	\$ 4.5	\$ 5.5	
	0%	9%	27%	45%	64%	82%	100%	
\$ -	\$0.00	\$136.07	\$408.21	\$680.36	\$952.50	\$1,224.64	\$1,496.78	
\$ 0.5	\$674.31	\$810.38	\$1,082.52	\$1,354.66	\$1,626.80	\$1,898.95		
\$ 1.5	\$2,022.92	\$2,158.99	\$2,431.13	\$2,703.27	\$2,975.42			
\$ 2.5	\$3,371.53	\$3,507.60	\$3,779.74	\$4,051.89				
\$ 3.5	\$4,720.14	\$4,856.21	\$5,128.35					
\$ 4.5	\$6,068.75	\$6,204.82						
\$ 5.5	\$7,417.37							

1. \$1.5 billion POBs issued in 2007
2. Assumed \$5.5 billion PERS UAAL in 2007
3. Funding ratio will be improved from 65.12% to 74.64% (based on preliminary \$10.27 billion PERS asset as of Dec 31, 2006)

Case Study (TRS)

Employer Contribution Rates
POBs (in billions)

Cash (in billions)	POBs (in billions)					
	\$ -	\$ 1.0	\$ 2.0	\$ 3.0	\$ 3.1	
	0%	32%	65%	97%	100%	
\$ -	57.65%	54.45%	51.25%	48.04%	47.72%	
\$ 0.5	49.72%	46.51%	43.31%	40.11%		
\$ 1.0	41.78%	38.58%	35.38%			
\$ 1.5	33.85%	30.65%	27.44%			
\$ 2.0	25.91%	22.71%				
\$ 2.5	17.98%	14.78%				
\$ 3.1	8.46%					

Savings on Annual Contribution Amount (in millions)
POBs (in billions)

Cash (in billions)	POBs (in billions)					
	\$ -	\$ 1.0	\$ 2.0	\$ 3.0	\$ 3.1	
	0%	32%	65%	97%	100%	
\$ -	\$0.00	\$19.31	\$38.62	\$57.93	\$59.86	
\$ 0.5	\$47.84	\$67.15	\$86.46	\$105.77		
\$ 1.0	\$95.69	\$115.00	\$134.31			
\$ 1.5	\$143.53	\$162.84	\$182.15			
\$ 2.0	\$191.37	\$210.68				
\$ 2.5	\$239.22	\$258.53				
\$ 3.1	\$296.63					

Savings on Employer Contribution Rates
POBs (in billions)

Cash (in billions)	POBs (in billions)					
	\$ -	\$ 1.0	\$ 2.0	\$ 3.0	\$ 3.1	
	0%	32%	65%	97%	100%	
\$ -	0.00%	3.20%	6.40%	9.61%	9.93%	
\$ 0.5	7.93%	11.14%	14.34%	17.54%		
\$ 1.0	15.87%	19.07%	22.27%			
\$ 1.5	23.80%	27.00%	30.21%			
\$ 2.0	31.74%	34.94%				
\$ 2.5	39.67%	42.87%				
\$ 3.1	49.19%					

NPV of Savings on 25-year Contribution Amount (in millions)
POBs (in billions)

Cash (in billions)	POBs (in billions)					
	\$ -	\$ 1.0	\$ 2.0	\$ 3.0	\$ 3.1	
	0%	32%	65%	97%	100%	
\$ -	\$0.00	\$272.14	\$544.28	\$816.43	\$843.64	
\$ 0.5	\$674.31	\$946.45	\$1,218.59	\$1,490.73		
\$ 1.0	\$1,348.61	\$1,620.75	\$1,892.90			
\$ 1.5	\$2,022.92	\$2,295.06	\$2,567.20			
\$ 2.0	\$2,697.22	\$2,969.37				
\$ 2.5	\$3,371.53	\$3,643.67				
\$ 3.1	\$4,180.70					

1. \$0.5 billion cash infusion and \$2.0 billion POBs issued in 2007
2. Assumed \$3.1 billion TRS UAAL in 2007
3. Funding ratio will be improved from 59.9% to 92.24% (based on preliminary \$4.63 billion TRS asset as of Dec 31, 2006)



Tax Issues





Tax Exempt Bonds vs. Taxable Bonds

- Taxable Bonds
 - Can be issued for any purpose
 - Complete flexibility with use of proceeds
 - Interest rate about 1% higher than tax exempt in current market

- Tax Exempt Bonds
 - Can only be issued for public capital projects
 - Earnings on proceeds are restricted to yield paid on bonds
 - 1% lower interest rate than taxable bonds in current market



The Difficulty with Tax Exempt

- Very difficult to identify appropriate GF funded capital projects to issue bonds for.
- Certificates of Participation issuance is the most viable option.
 - However the existing, yet unexpended GF funded capital projects are small, for private purposes, short lived acquisitions, operational grants, or federal match.
 - Fiscal Year 2008 capital budget is only \$100 million, all of which could not be funded with tax exempt bonds.
- Any use of tax exempt bonds to fund capital projects would have to be coincidental, rather than integrated, to any use of on hand cash to fund PERS/TRS contributions.



Take-aways





Take-aways

1. POB issuance is a financial transaction which will lower the cost of funding the UAAL by the state and local governments – POBs issued in the near future will be at a cost lower than 8.25% charged by the pension system.
2. We are in a very favorable interest rate environment – take advantage of it!
3. Risks associated with POB issuance are quantifiable and statistically justified by the rewards.
4. Doing nothing is not a viable option.



Q & A



An Introduction to



Pension Obligation Bonds

ROGER L. DAVIS



ORRICK

TABLE OF CONTENTS

ABOUT THE AUTHOR

Roger L. Davis is chair of the Public Finance Department at Orrick, Herrington & Sutcliffe LLP, the premier bond counsel firm in the country. Mr. Davis is also head of Orrick's Pension Obligation Bond Group and has worked on more than 20 POB issues in various states.

Members of Orrick's Pension Obligation Bond Group are shown on the contact list on the inside of the back cover of this booklet.

DISCLAIMER: Nothing in this booklet should be construed or relied upon as legal advice. Instead, this booklet is intended to serve as an introduction to the general subject of the use of pension obligation bonds, from which better informed requests for advice, legal and financial, can be formulated.

Published by
Orrick, Herrington & Sutcliffe LLP

All rights reserved.
Copyright © 2003 by Orrick, Herrington & Sutcliffe LLP

No part of this book may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording or any information storage and retrieval system, without permission in writing from the publisher.

Chapter 1.	Introduction	1
Chapter 2.	Pension Obligations	3
	A. Unfunded Accrued Actuarial Liability (UAAL)	3
	B. Normal Annual Contributions	4
Chapter 3.	Reasons For Issuing POBs	5
	A. Interest Rate Savings	5
	B. Discounts	6
	C. Arbitrage	6
	D. Budget Relief	7
	E. Labor Relations Benefits	7
	F. Better than the Alternatives	8
Chapter 4.	Possible Disadvantages	9
Chapter 5.	Types of POBs	11
	A. Security	11
	B. Credit Ratings/Borrowing Capacity	13
	C. Structure	14
	D. Payments to the Pension Fund: Whole or Part	17
Chapter 6.	Tax Issues	19
	A. Taxable Bonds	19
	B. Tax-Exempt POBs Prior to 1986 Tax Act	19
	C. Tax Reform Act of 1986; Transition Rules	20
	D. Columbus Case	21
	E. Tax-Exempt Working Capital Bonds	22
	F. Investment of POBs in Municipal Obligations	23
	G. Other Considerations: Effect on TRANS	24
Chapter 7.	Federal Reimbursement Issues	25
Chapter 8.	New York	27
Chapter 9.	California	31
Chapter 10.	Oregon	35
Chapter 11.	Similar To POBs	39
Contacts.	Orrick's Pension Obligation Bond Group	Inside Back Cover

CHAPTER ONE

Introduction

Pension obligation bonds ("POBs") are bonds issued by a state or local government to pay its obligation to the pension fund or system in which its employees (or others for whose pension benefits it is responsible) are members. POBs are an increasingly popular way for state or local governments to accomplish a variety of financial and other (including political) objectives.

According to Thomson Financial, during the past decade there have been at least 275 POB issues by state and local government issuers in at least 22 states.

The purpose of this pamphlet is to introduce interested parties to the reasons why POBs are issued, advantages/disadvantages, structure alternatives, federal tax issues, and representative programs in three states where POBs are particularly popular.

The author is chair of the Public Finance Department at Orrick, Herrington & Sutcliffe LLP and has been bond counsel on more than twenty POBs in various states. Orrick is the nation's premier bond counsel firm, ranked number one for more than a decade,¹ with extensive experience in all types of POB and similar financings.²

¹ Rankings for securities transactions of various types are performed annually by Thomson Financial, which has ranked Orrick number one in the country as bond counsel since prior to 1990. In an average year, Orrick handles more than 500 bond issues, aggregating more than \$20 billion.

² Orrick is ranked by Thomson Financial as the number one bond counsel in the country for POBs over the last decade, with more than 4 times as many such issues as the second ranked firm.

CHAPTER TWO

Pension Obligations

Pension obligations generally fall into two categories:

A. Unfunded Accrued Actuarial Liability (UAAL)

The unfunded accrued actuarial liability ("UAAL") is determined by the actuary for the pension fund to be the amount by which the pension fund is short of the amount that will be necessary, without further payments from the state or local government, to pay benefits already earned by current and former employees covered by the pension system. The UAAL is based on assumptions (in some cases established by the actuary and in some cases by the pension system or by the state or local government) as to retirement age, mortality, projected salary increases attributed to inflation, across-the-board raises and merit raises, increases in retirement benefits, cost-of-living adjustments, valuation of current assets, investment return and other matters. In order to avoid volatility in the UAAL, based on swings in market valuation, the investment gains and losses on assets in the pension fund are often recognized (sometimes referred to as "smoothed") over a 3 to 5 year period.¹ The state or local government is obligated to amortize the UAAL over a period established by law or agreement with the pension system, typically at an assigned interest rate established by the pension system, which assigned interest rate is usually the same as the actuary's assumed rate of investment return on pension fund assets (sometimes referred to as the "Actuarial Rate").

¹ Note that the smoothing methodology referred to may result in "unrealized" or "lagging" unfunded liability. See discussion of POB possibilities in footnote 4.

B. Normal annual contribution

In addition to making payments toward any UAAL, the state or local government is required to make payments to the pension fund each year in respect of the present value of the benefits being earned by the current employees covered by the pension fund (that is, the amount being earned by those employees with each paycheck necessary to pay future retirement benefits, based on assumptions of mortality rates, salary increases, assumed rate of investment income and the other assumptions referred to in the preceding paragraph), generally referred to as the "normal annual contribution."

CHAPTER THREE

Reasons For Issuing POBs

The reasons why state or local governments issue POBs vary from issuer to issuer and from time to time with economic conditions and other circumstances. However, these reasons generally fall into one or more of the following categories:

A. Interest Rate Savings

As described in Chapter Two, most pension systems assign an interest component to the payments the state or local government is required to make in respect of its UAAL. Assigned interest rates currently generally range from 7 $\frac{1}{2}$ % to 8 $\frac{1}{4}$ % depending on the particular pension system. When taxable bond rates are low, and as of fall 2003 they are roughly 5.95% or less for 30 year debt, then POBs can function like a classic interest rate savings refunding. For example, if the assigned rate is 7.5% on a UAAL of \$100,000,000, the annual all in cost would be roughly \$8,500,000 assuming a 30 year amortization, compared to an all in cost of \$7,300,000 on POBs amortized over the same period assuming a 5.95% interest rate and costs of issuance of 1%. These savings to a degree can be front loaded or otherwise structured to occur when most needed (see Section C of Chapter 5).

On the other hand, because the factors on which the UAAL is based are constantly changing (such as mortality and investment return), the final amount of interest rate savings cannot be determined with certainty. Also, the assigned interest rate may change from time to time during the life of the bond issue, and, at least theoretically, the amount of interest rate savings could become negative (even if all the other factors remain the same) if the assigned interest rate were to drop and remain below

the bond interest rate for a substantial period. So far this has not occurred, even though the assigned interest rate in some cases has dropped by more than one percentage point since the mid-1990s. This possibility is furthermore generally considered to be unlikely, because the assigned interest rate is based on an assumed investment rate of return which reflects investments with a higher risk profile and, therefore, higher projected return than the POBs.

B. Discounts

In some cases, it may also be possible to negotiate discounts with the pension system for early payment of the normal annual contribution or even the UAAL (which may reflect the pension fund's assumed rate of investment return or even its then current investment opportunity). It may also be an opportunity to renegotiate other terms of the pension obligation.

C. Arbitrage

Generally, pension funds may invest in a much broader range of investments than the state or local governments, and the size and diversity of the pension fund's portfolio allows for a higher risk profile than the state or local government could prudently sustain with its own investments. As mentioned above, this is why the assumed rate of investment return is generally materially higher than the bond rate. The actual investment performance of most pension systems (at least in most years) has substantially exceeded the assumed interest rate. Therefore, there is the possibility that proceeds of the POBs will be invested by the pension fund at significantly higher return than the interest cost on the POBs (even if interest on the POBs is taxable).

In almost all cases, the benefit of earnings on investment of bond proceeds in the pension fund will be credited to the state or local government issuer either in reduced

UAAL, or reduced normal annual contribution or both. In some cases, the allocation of this benefit is subject to negotiation between the state or local government and the pension system and may even be decided by the state or local government each year. This benefit from earnings is why interest on POBs is generally not exempt from federal income tax (see Chapter 6). So this arbitrage is not the typical municipal bond arbitrage derived from borrowing at tax-exempt rates and investing at taxable rates, but rather what might be called risk arbitrage derived from borrowing against the credit of the state or local government and participating through the pension fund in a portfolio of investments that is designed to produce a higher yield and manage the higher risk through diversification. Of course, there is no guaranty that such arbitrage will be positive.

D. Budget Relief

Particularly in the current environment of substantial budget deficits, POBs are being used for budget relief. This may be accomplished by:

- (1) reamortizing the UAAL by replacing the obligation to the pension fund with POBs having a longer term and/or lower payments in the early years (or even no debt service in the early years if capital appreciation bonds (CABs) or capitalized interest is used); and/or
- (2) funding the normal annual contribution for the current (and maybe the next) fiscal year (to the extent permitted by applicable state law).

E. Labor Relations Benefits

Some state or local governments have used POBs, at least in part, to improve relations (or negotiations) with its employees and their unions by funding unfunded pension liability to those employees.

F. Better Than The Alternatives

In some cases, POBs are simply better than the alternatives: (i) paying more into the pension fund; (ii) asking employees to pay more into the pension fund; (iii) reducing benefits; or (iv) hoping that gains on pension fund investments will substantially exceed the assumed rate of investment return.

CHAPTER FOUR

Possible Disadvantages of POBs

Despite the foregoing benefits of POBs, there are a few possible disadvantages:

- A. In some jurisdictions, a state or local government may negotiate or even unilaterally make changes in its pension obligation, perhaps by postponing payments or changing assumptions. POBs replace this potentially flexible pension obligation with a more immutable bond obligation.
- B. As explained in Chapter 3, while unlikely, it is possible that the assigned interest rate will drop below the bond interest rate or that the pension fund will have negative earnings, in each case for a sustained period.
- C. If the pension fund enjoys higher than expected earnings, the pension fund may become overfunded and result in temporary contribution holidays, but also can lead to increases in retirement benefits that may be costly to sustain at some point in the future.
- D. POBs result in payment to and investment by the pension fund of a lump sum amount that otherwise would have been paid and invested in increments over a period of years, concentrating rather than spreading market timing risks.
- E. Almost all POBs are taxable and most taxable bonds with fixed interest rates are sold as noncallable bonds. Adding a redemption feature will ordinarily result in a materially higher interest rate cost than the same redemption feature in tax exempt bonds. Therefore, taxable noncallable bonds may be expensive to refund or defease, although there have been a number of successful tender offer refundings of taxable POBs (that is, a tender offer was made for the prior bonds and the tender price was paid with proceeds of new refunding bonds).

Another way to address this concern is by using variable rate bonds, which may contain redemption provisions without additional interest rate cost, and may be accompanied by a floating-to-fixed interest rate swap if a fixed rate obligation is desired.

Note that many of these issues can be addressed in whole or in part by using POBs to fund less than all of the UAAL.

CHAPTER FIVE

Types of POBs

A. Security

Most POBs are payable from the general fund of the issuing state or local government. As such, they must either satisfy or be exempt from the debt limitation provisions typically found in the applicable state constitution and, accordingly, generally fall into one of the following three categories:

1. **General obligation bonds**, which term generally refers to bonds that satisfy any constitutional debt limitation and are backed by the full faith and credit and taxing power of the issuing state or local government. An example is the \$10,000,000,000 State of Illinois General Obligation Bonds Pension Funding Series of June 2003 (Taxable), the largest POB issue to date. A variation is full faith and credit limited tax bonds payable from available general funds but without any obligation to levy additional taxes. See discussion in Chapter 10.

2. **Obligations imposed by law**, which term refers to an exception recognized in a few states from the otherwise applicable debt limitation contained in the state constitution. It applies to obligations imposed on the state or local government by the constitution or by statute or, in some cases, by court judgment as distinguished from a voluntary exercise of the borrowing power by the state or local government. Most pension obligations would qualify and, in states in which the obligations imposed by law concept applies, bonds issued to fund those pension obligations (POBs) are considered to have the same legal character as the pension

obligations themselves. POBs issued in California during the past decade have all been obligations imposed by law. See discussion in Chapter 9.

POBs issued as obligations imposed by law generally cannot include reserves or capitalized interest because those components of the obligation are not considered to be imposed by law, even on the theory they are essential to marketing the bonds (because so many obligations imposed by law POBs have been issued without them). On the other hand, costs of issuance may be included. The inability to include capitalized interest means that it may be difficult to achieve complete budget relief in the early period following issuance of the bonds without resort to capital appreciation bonds (CABs).

3. **Annual appropriation bonds**, which term refers to bonds that are not considered debt subject to a constitutional debt limitation because the state or local government issuer has no legal obligation to pay them and payment is therefore subject to annual (or other periodic) appropriation of funds for that purpose at the discretion of the legislature or governing body of the state or local government issuer. Examples include the \$773.5 million POBs issued in 1996 for the State of New York and the \$2.8 billion POBs issued in 1997 for the State of New Jersey.

4. **Other.** In the mid-1980s and occasionally since, some cities and counties in California issued POBs as so called asset-strip lease revenue bonds or certificates of participation (COPs). The city or county leased existing facilities (with a value at least equivalent to the amount of bonds/COPs to be issued) to a joint powers authority or other governmental entity or to a nonprofit corporation, simultaneously leasing them back; the leaseback was assigned to a trustee and bonds/COPs were issued secured by the leaseback payable from the city or county's general fund, and the proceeds of the bonds/COPs were paid to the pension fund net of costs of issuance and reserves and capitalized interest retained by the trustee.

In certain circumstances, it may also make sense to use revenue bonds as POBs (for example, if the issuer is a revenue producing enterprise, authority or district). (See also Chapter 10.)

B. Credit Ratings/Borrowing Capacity

Because POBs replace existing pension obligations, they are not generally viewed as adding to the debt burden of the state or local government issuer (much like a conventional refunding).⁴ To quote the rating agencies:

"Moody's believes the issuance of pension obligation bonds (POBs) is one effective way of addressing an unfunded liability. Since POBs reduce the cost of funding an unfunded liability, their issuance is not by itself a credit weakness. However, the planning and analysis conducted by a local government as part of the decision to grant expanded benefits, the government's plan for funding any unfunded pension liability, and its ability and willingness to budget appropriately for any attendant higher costs, are reflective of the quality of the government's overall financial management. These factors, therefore, will be considered in our assessment of a government's general credit quality."

"Standard & Poor's factors the effects of a pension obligation bond strategy into the long-term rating of the sponsor. Standard & Poor's has viewed POBs as a strategy for savings on carrying charges as long as the transaction was structured conservatively and the assumptions were reasonable and attainable. This requires a clear financing plan including reasonable assumptions and manageable leverage. Prudent expectations for investment returns and the cautious use of resultant savings help insure a POB's success. Another positive factor for a POB is, of course, to be fortunate enough to sell the bonds in a low interest rate environment, thereby increasing the spread between interest costs and investment return expectations and lowering the risk of underperformance."

"Fitch believes that POBs, if used moderately and in conjunction with a prudent approach to investing the proceeds and other pension assets, can be a useful tool in asset-liability management. However, a failure to follow balanced and prudent investment practices with respect to POB proceeds could expose the sponsor to market losses.

⁴ Note that to the extent the POBs fund the normal annual contribution, new long term debt is created which could have an affect on credit ratings not present if the POBs fund only the UAAL.

Because a sponsor's unfunded pension liability is already factored into the rating, the issuance of POBs simply moves the obligation from one part of the balance sheet to another. However, Fitch notes that POBs create a true debt, one which must be paid on time and in full, rather than a softer pension liability that can be deferred or rescheduled from time to time during periods of fiscal stress.

Consequently, POBs can have a significant effect on financial flexibility over time.

The actual ratings on the POBs will depend primarily on legal structure. General obligation bonds and annual appropriation POBs should be rated the same as the issuer's other general obligation or annual appropriation debt. Obligations imposed by law POBs are generally rated in between: a notch below the issuer's general obligation bond rating and a notch above its lease or other annual appropriation debt.

C. Structures

Because POBs are generally payable directly from the general fund of the state or local governmental issuer, the structure of the bond issue is usually simple and straightforward, varying primarily in interest rate mode, using one or a combination of the following:

1. **Fixed rate bonds.** Because most POBs are issued, at least in part, to achieve interest rate savings, most POBs are issued as fixed rate bonds. The advantages are the same as fixed rate bonds generally: namely, they lock in interest cost, and with interest rates at historic lows, this is a very attractive prospect in itself. The disadvantages are: (i) the assigned interest rate on the pension obligations funded with POBs is not fixed, so interest savings cannot be fixed with certainty (see Section A of Chapter 3); and (ii) fixed rate taxable bonds are usually sold as noncallable, so they cannot be easily refunded or defeased if rates drop or circumstances change (see discussion Section E of Chapter 4).

2. **Variable rate demand bonds.** Variable rate demand bonds are bonds the holders of which may tender them back to the issuer or its agent upon short notice

(usually 7 days, but may be 1 day, 1 month or other periods), for a purchase price equal to par plus accrued interest. As a result, they bear interest at rates like, and have some other characteristics of, short term obligations. Variable rate demand bonds generally require a bank letter of credit, standby purchase agreement or other facility to assure liquidity in the event bonds are tendered and cannot be remarketed. Unless the issuer is highly rated, variable rate demand bonds are typically also credit enhanced with either bond insurance or bank letter of credit or other credit facility. The advantages of variable rate demand POBs are that (i) their interest rates are generally lower than fixed rate bonds, and (ii) they are usually subject to redemption at any time without premium and at no extra interest rate cost for the right to redeem. However, while the interest rate usually starts out lower than fixed rate bonds, the rate is variable and subjects the issuer to interest rate exposure and risk to the interest rate savings objective and to the risk arbitrage pension fund investment objective for issuing the POBs (see discussion in Sections A and C of Chapter 3). Interest rates may be affected not only by market conditions but also by the financial condition of the issuer or the credit provider or liquidity provider. In addition, there are risk, costs and aggravation associated with renewal of any bank liquidity or credit facilities, which usually have a term of one to five years, compared to the POBs which typically have a term of more than 20 years.

3. **Auction rate bonds.** Auction rate bonds appear to be the most popular current variable rate mode at this time because they do not require a bank letter of credit, standby purchase agreement or similar liquidity facility required for variable rate demand bonds or commercial paper. This is because auction rate bonds are not puttable back to the issuer but instead are subject to periodic auction (typically every 7, 28 or 35 days) if the holder would like to dispose of its bonds other than by direct sale. The interest rate is reset by the auction price and tends to be materially less than the then current fixed rates (for example, in the fall of 2003, 7-day auction rate taxable POBs bore rates of roughly 1.05%-1.15% compared to 30 year taxable fixed rates of approximately 5.95%). However, there is no assurance that auction rates will not increase to exceed the fixed rate at which the POBs could have been originally issued. If there is an auction with no buyers (*i.e.*, a failed auction), the interest rate

usually goes to the maximum rate (typically 12 to 15%). Failed auctions are rare. The primary reason they may occur is (i) a cloud of some kind on the tax-exemption of the bonds (for example, an IRS audit or challenge to the tax-exemption of similar bonds), which is not a risk for most POBs because they are taxable; or (ii) a shock to the security for the bonds (for example, bankruptcy of an important source of revenue) which is improbable with general fund obligations like POBs unless the issuer goes bankrupt (which states cannot do under U.S. bankruptcy law, and cities and counties do very rarely).

4. Indexed bonds. Indexed bonds are variable rate bonds that are not subject to tender back to the issuer and, therefore, do not require a bank liquidity facility, and bear interest at a fixed spread over a market index (typically either three or six month LIBOR) reset at the end of each accrual period (typically quarterly if three month LIBOR is used or semiannually if six month LIBOR is used). LIBOR refers to the London Interbank Offered Rate and is published daily as page 3750 on the Telerate, Inc. news and information service (referred to as the Official LIBOR Page). Indexed bonds of this type are used primarily to facilitate marketing of POBs outside of the U.S. where investors are more accustomed to LIBOR based investments, but are also attractive to many U.S. investors as well. Like auction rate bonds, index bonds may be subject to redemption without penalty. However, also like auction rate bonds there is no assurance that LIBOR indexed rates will not increase to exceed the fixed rate at which the POBs could have been originally issued. However, unlike auction rates, the LIBOR index is not affected by events affecting the POBs issuer or the POBs. Index bonds may also be swapped to fixed more efficiently and with little or no basis risk compared to auction or other variable rate bonds because the global swap market is primarily LIBOR based.

5. Capital appreciation bonds. Capital appreciation bonds (CABs) are bonds that bear no current interest, which instead is accrued, compounded (usually semiannually) and paid at the maturity of the bonds. They are used primarily to reduce debt service in the early years. A variation is convertible CABs, that function as CABs for several years and then convert on a certain date to current interest

bonds (with interest paid on the then accrued value of the bonds, being the original principal amount plus the amount of accrued, compounded interest up to the conversion date). The disadvantage of CABs is that higher rates of interest are required in order to market them.

6. Swaps. If variable rate bonds are used, the resulting interest rate exposure may be swapped to a fixed rate, in whole or in part, using a floating-to-fixed interest rate swap. While swaps may often make a great deal of sense in this context they are complex financial investments and beyond the scope of this pamphlet. It is important to make sure that if a swap is to be used, it is consistent with the issuer's objectives and does not itself expose the issuer to risks or consequences the issuer does not fully understand or are inconsistent with its objectives. For example, if the purpose of using variable rate POBs is to allow for refunding or early redemption if rates drop or other circumstances change, the termination payment that may be due on early termination of the swap may offset the benefit of and effectively prevent refunding or redemption. There are also other circumstances in which a substantial termination payment may be due from the state or local government such as default of the swap provider or downrating of either party, as well as other terms that can be modified to suit the state or local government's objectives. Expert advice should be sought before entering into any swap.

D. Payments to the Pension Fund: Whole or Part

POBs may be issued to pay all or any part of the UAAL or (depending on applicable state law) the normal annual contribution.⁵ Frequently, issuers choose to use POBs to fund only a portion of the UAAL, generally to avoid or reduce the concerns described in Chapter 4. The portion of the UAAL funded may be (1) a percentage of the total UAAL as of the date of issuance of the POBs, or (2) all of

⁵ Depending on state law and financing structure, it may also be possible to finance future year's normal annual contribution and/or unfunded liability created by investment losses not yet realized due to actuarial smoothing methodologies (which phase in investment gains and losses over a period of, usually 3 to 5, years).

certain years contributions to the UAAL. If agreed to by the pension system, the second approach can result in suspension of all UAAL contributions during those years (for example, the next succeeding 10 years). At the end of the period, the UAAL will be recalculated and amortized over the remaining original term of the UAAL. The risk of this second approach to partial payment of the UAAL, which is much less common than the first approach, is that if investment performance of the pension fund is substantially below the assumed rate of return, there could be a significant increase in the amount of UAAL to be amortized over the remaining term. To a degree, that risk can be addressed by subsequent issues of POBs (before or after the date of recalculation).

CHAPTER SIX

Tax Issues

A. Taxable Bonds

Most POBs are taxable. That is, interest on the bonds is included in gross income for federal tax purposes, although they are usually exempt from income taxes of the state in which the issuer is located. This affects not only the interest rate at which the POBs are sold but also the types of investors to which they are marketed (for example, corporate pension funds, charitable endowments and others not subject to federal income tax and, for some of the larger issues, non-U.S. investors). There are, however, a few circumstances in which POBs may be tax-exempt.

Why most POBs are taxable, with these few exceptions, is explained below.

B. Tax-Exempt POBs Prior to 1986 Tax Act

Prior to the enactment of the Tax Reform Act of 1986 (the "1986 Tax Act"), POBs that were properly structured could bear interest that was excluded from gross income for federal tax purposes. However, to get tax-exempt treatment, investment of bond proceeds for the benefit of the covered employees and former employees had to be designed so that the issuer/employer did not benefit from the investment in any way other than relieving the issuer of the responsibility of paying its retirees.

If proceeds deposited in the pension fund were expected to be invested in securities or obligations with a yield higher than the yield on the POBs, the issuer's obligation to make additional contributions into the fund would be reduced in the future, a

prohibited anticipated direct benefit from the investment of the bond proceeds by the pension fund.

However, the situation was different where the issuer contracted with someone else to take over the responsibility of making payment to the retirees and paid for that transfer of risk with proceeds of POBs – for example, by purchasing an insurance company annuity whereby the insurance company took over all liability for the payment of the pension benefits. In that case, the insurance company bore the risks and benefits of investment return – the issuer got no benefit from investments made by the insurance company even if the expected investment return was reflected in the price paid by the issuer for the annuity policy. In addition, the purchase of an annuity was not treated as the purchase of a "security" or "obligation" under the tax law. A number of tax-exempt POB transactions were consummated in the early 1980's in which the proceeds were deposited into a pension fund and were used to acquire insurance company annuity contracts.

C. Tax Reform Act of 1986; Transition Rules

1. *Stopping New Issues of Tax-Exempt Pension Bonds.* As a result of the threat of a proliferation of tax-exempt POB issues, Congress decided to amend the tax law to prevent the investment of tax-exempt bond proceeds in annuity contracts. New rules were adopted in the 1986 Tax Act. "Investment type property" including annuity contracts, was added to "securities" and "obligations" as potential arbitrage investments. In addition, because of the urgency with which it viewed the matter, Congress included a special effective date rule in the 1986 Tax Act relating to annuity contracts which applied to all bonds issued after September 25, 1985. The 1986 Tax Act essentially ended the issuance of tax-exempt POBs for the purpose of depositing the proceeds into a pension fund or for the purpose of purchasing annuities to replace the issuer's responsibilities to its retirees, except as described below.

2. *Transition Rules for Refundings of POBs.* The status of refundings of pre-1986 Tax Act POBs was not specifically addressed in the 1986 Tax Act. In connection with two later tax acts, the Technical Corrections Bill of 1988 and Technical and

Miscellaneous Revenue Act of 1988, Congress attempted to clarify its position on refundings. While the statutory language and legislative history are a bit confused, the related House, Senate, and Conference Committee Reports indicate that Congress intended generally to permit one advance refunding of pre-September 25, 1985 POBs (at least where the amount of the refunding is not greater than the amount of prior bonds). Additionally, the legislative history indicates that Congress intended to permit any number of current refundings of pre-September 25, 1985 POBs where the refunding bonds do not additionally burden the tax-exempt market, but merely replace existing tax-exempt debt.

D. Columbus Case

The State of Ohio created a state fund into which municipal corporations in the State were required to transfer on January 1, 1967, all existing assets and liabilities of their local pension funds for police and firefighters. Under the State law, all pension liabilities accruing after the transfer would be supported by current employer and employee contributions. However, while the State fund completely assumed the assets and liabilities of a city's retirement fund, the law mandated the city pay to the fund, either immediately or over time, an amount equal to the present value of the accrued but unfunded liability determined at the time of the transfer. The City of Columbus opted to satisfy its obligation over time together with the required interest.

In 1993, the State modified the law to allow any city still owing money to the fund to extinguish its remaining UAAL in return for a single payment equal to 65% of the then unpaid principal balance. The City decided to prepay its obligation. However, upon hearing that the City was going to issue tax exempt bonds to fund its prepayment, representatives of the Internal Revenue Service notified the City that they would assert that interest on these bonds would be taxable. The City sought a private letter ruling from the Internal Revenue Service and received an adverse ruling which it appealed to the Tax Court.

In the court proceedings the Service argued – among other things, that the discount the City received on the prepayment of its obligation to the fund was a form of

investment return and thus created impermissible arbitrage profit. The Service reasoned that the pricing of the prepayment reflected the expectation of the State fund that it would be able to invest the amount of the prepayment at a yield materially higher than the yield on the City's bonds. As a result, the Service believed that both the City and State fund would benefit from the earnings on the investments. In addition, the Service argued that the prepayment constituted the use of bond proceeds to acquire "investment-type property" at a yield higher than that on the bonds (after taking into account the discount received on the prepayment) in that absent the discount pricing of the prepayment there would be no economic savings for the City.

Ultimately, the City prevailed on appeal as the Court of Appeals concluded that there was an existing obligation of the City to the State fund, the City would not benefit from the investment of amounts by the State fund and the prepayment of the City's own debt obligation to the State fund did not constitute the acquisition of investment type property by the City. The City was then able to refund its obligation to the State fund by issuing tax exempt POBs.

While the unusual facts in this case have application beyond the City of Columbus, such application is likely to be fairly limited and to attract unfavorable attention from the Internal Revenue Service.

E. Tax-Exempt Working Capital Bonds

While directly issuing bonds to deposit the proceeds into a pension fund does not appear to be permitted under current tax law governing tax-exempt bonds, in certain cases it may be possible for a state or local government to indirectly fund the current year's pension deposit. For example, a state or local government may issue short term tax or revenue anticipation notes or long term working capital bonds to finance a cash flow budget deficit or a so-called structural budget deficit. The deficit analysis would include any cash flow deficit relating to the state or local government's obligation to deposit amounts into its pension fund.

It may be that this type of financing is best done so that the bond proceeds are not required to be deposited in the pension fund, but rather, are used to fund deficits

created by working capital expenditures including the deposit of amounts into the pension fund. In other words, it is important that the bond proceeds not be "traced" into the pension fund or required to be deposited there and the bonds should not be called Pension Obligation Bonds.

Among other things, long term bonds of this type would bring into play the application of some complex federal tax rules relating to when proceeds can be treated as spent, allocation of the deficit in sizing the issue, permitted amortization structure, the application of so-called "other replacement proceeds" rules, applicable yield and other investment restrictions, post-issuance compliance matters, plus the intersection in sizing and in post-issuance compliance with the issuance of normal tax or revenue anticipation notes and any other short term or long term working capital obligations.

F. Investment of POB Proceeds in Municipal Obligations

The primary tax problem in the use of tax-exempt POBs to make a deposit to a pension fund is that the proceeds are not treated as spent, but rather are treated as invested. Moreover, under the so-called "proceeds spent last" rule applicable to working capital financings, these proceeds cannot be treated as paid out to pension recipients until all other available amounts are first expended, which as a practical matter, means that the proceeds will never be deemed expended. Unless the investment yield on the investments in the pension fund is not more than the yield on the bonds, the bonds will become taxable arbitrage bonds. In addition, the "hedge bond" rules would result in the bonds being treated as taxable hedge bonds unless the issuer actually expected to spend the proceeds within a three- or five-year time frame, taking into account the "proceeds spent last" rule.

However, under both the arbitrage rules and the hedge bond rules, interest on the bonds used to fund the pension fund could be tax exempt if the issuer invested the proceeds of the bonds in municipal obligations the interest on which is not subject to the alternative minimum tax (so called "non-AMT" municipal bonds). Under these provisions as long as the amount of non-AMT municipal bond investments in the

pension fund is at least equal to 95% of the amount of POBs outstanding at any time, interest on the POBs will be tax exempt. As the POBs are amortized, there is a similar reduction in the amount required to be invested only in non-AMT municipal bonds in the pension fund.

While this structure allows for POBs to be issued as tax exempt, the benefit of the tax exemption on the bonds may be outweighed by the limitation on the type of investments allowed with the proceeds.

G. Other Considerations: Effect on TRANS

Tax and revenue anticipation notes (TRANS), are typically issued by state and governmental units of all sizes to fund the annual cash flow deficit which arises due to the timing mismatch between annual revenues and annual expenses. TRANS are almost always issued as short term notes with maturities of 13 months or less and are repaid at or shortly after the end of the fiscal year by which time it is expected that revenues will have "caught up" with expenses. To the extent the POB proceeds are used to fund a deposit to the pension fund that otherwise would have been made out of current year's revenues, the deficit will be likely be reduced by the same amount, impacting the sizing of any TRANS issued for that year. The one circumstance where this would not happen is if the calculation of the maximum cash flow deficit used in sizing the TRANS shows that it is incurred prior to the time of the pension deposit. In that case, the use of proceeds to make that deposit would not have any impact on the size of the TRAN issue.

CHAPTER SEVEN

Federal Reimbursement Issues

Certain costs of state and local government in administering programs under grants from or contracts with the federal government are eligible for reimbursement from the federal government. Such costs include compensation and benefits, including pension benefits, of state or local government employees for the time devoted to the administration of such programs. Such allocable pension benefit costs even include the interest assigned to the state or local government's unfunded liability. The principles governing such reimbursement are set out in Office of Management and Budget Circular A-87. Some states have similar programs for reimbursement of local governments for costs related to the administration of state programs.

POBs replace the state or local government's payment of some or all of these pension costs with payment of the principal of and interest on the POBs. Issuers will want to be comfortable that the federal government will treat debt service on the POBs as the surrogate for the pension obligations funded or refunded with the POBs and will continue to reimburse its allocable share. Statements have been issued by the Office of Management and Budget and the Department of Health and Human Services to the effect that the POBs, including principal (representing amounts paid to the pension fund), interest and costs of issuance, will be allowable as the pension costs funded or refunded thereby, so long as the POBs are not more costly to the federal government than the regular pension costs funded or refunded over the remaining life of the unfunded liability. The same principles should apply to refunding POBs. Further details of federal and state reimbursement programs are beyond the scope of this pamphlet.