AK LEGISLATURE FINANCE COMMITTEES FILES 2007-2008 3149

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."

Prudently Structured, POBs are Ratings Neutral

Failure to fully fund the actuarially required contribution signals fiscal stress to the market ("willingness to pay").

- Consistent underfunding is considered a credit negative.
- Funding ratios below 80% are a potential negative
  - Actuarially Required Contribution needed to "catch up" may "crowd out" other priorities, reducing the state's financial flexibility.
- Rating agencies generally view POBs as an acceptable tool for reducing the cost of an already existing liability.
- Significant term extensions and/or payment holidays are *not* viewed positively.

Risks

Risks Overview

- Investment Risk – POB financing is successful as long as the return of investment of proceeds exceed POB cost.
- Political Risk – Overfunded pension system can lead to political pressure to increase pension benefits, which can cause further increased pension liability in the future.
- Market Risk – Prudent investment of POB proceeds in early years is important.

Investment Risk Analysis

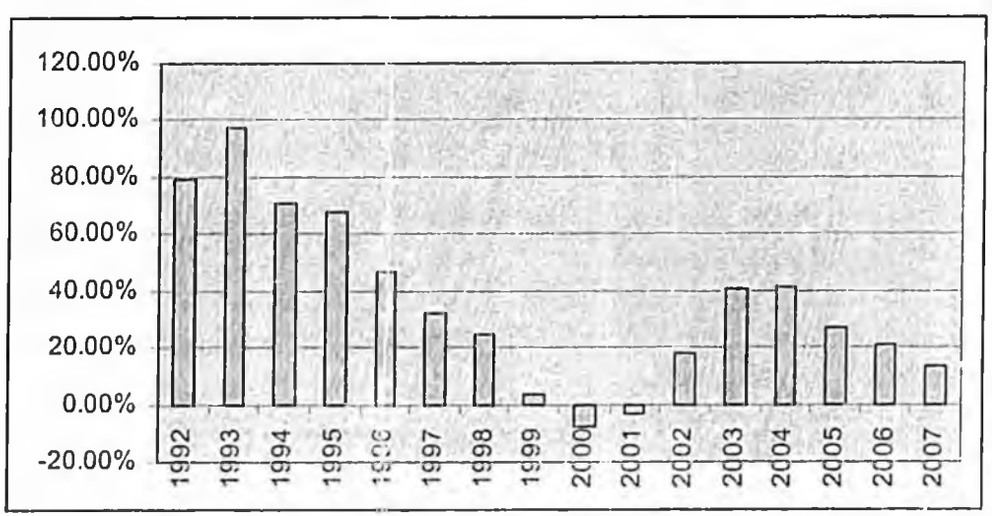
As long as those bond-funded assets earn more than 5.25%, we are better off for having borrowed.

- With the current low interest rate environment, POB issuance with cost around 5.25% is achievable.
- Historical investment returns of PERS and TRS indicate that we can outperform 5.25% most of the time.
- Simulations of future investment returns show that there are high possibility that we are going to outperform 5.25%.

Investment Risk (PERS)

FY	PERS ROR	Estimated Cost of Borrowing	Accm. Returns as of EOY FY07	Annualized Returns as of EOY FY07
2007	18.88%	5.75%	13.13%	13.13%
2006	11.69%	5.55%	20.63%	9.83%
2005	8.86%	5.04%	26.82%	8.24%
2004	14.73%	5.02%	40.92%	8.95%
2003	3.82%	4.76%	40.65%	7.06%
2002	-5.40%	5.36%	18.16%	2.82%
2001	-5.30%	5.77%	-3.29%	-0.48%
2000	10.12%	6.78%	-8.21%	-1.07%
1999	10.65%	6.40%	3.38%	0.37%
1998	14.62%	6.01%	24.72%	2.23%
1997	18.07%	7.10%	31.90%	2.55%
1996	13.70%	7.19%	46.90%	3.26%
1995	15.56%	7.32%	68.16%	4.08%
1994	2.66%	7.84%	70.80%	3.90%
1993	14.25%	6.62%	96.98%	4.62%
1992	11.80%	7.76%	79.24%	3.71%

Estimated Cumulative Net Return to 2007 (PERS)

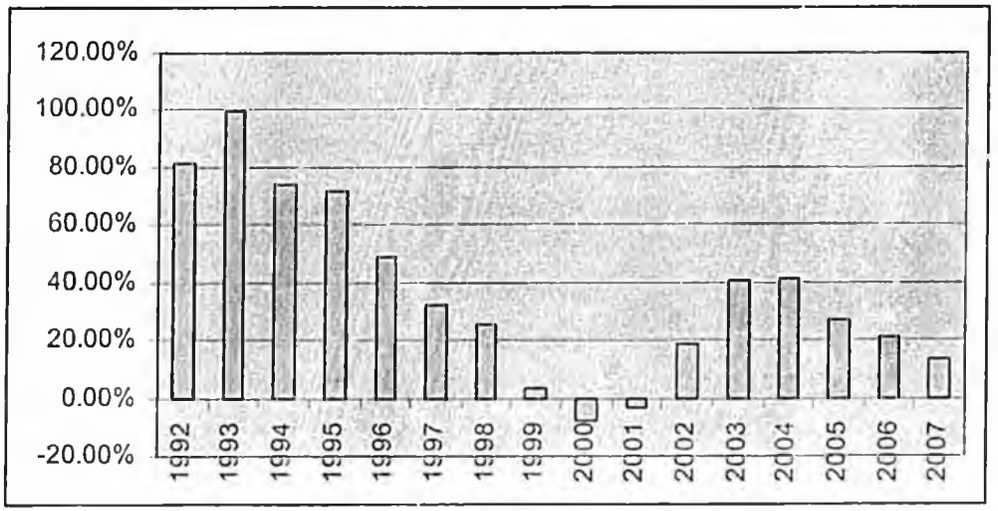


- Based on PERS actual investment history, we can see what the cumulative net return to 2007 might have been if POBs had been issued in any given year.
- For 14 out of 16 years the issuance of POBs would have resulted in a gain to the pension system.

Investment Risk (TRS)

FY	TRS ROR	Estimated Cost of Borrowing	Accm. Returns as of EOY FY07	Annualized Returns as of EOY FY07
2007	18.89%	5.75%	13.14%	13.14%
2006	11.72%	5.55%	20.68%	9.85%
2005	8.90%	5.04%	26.92%	8.27%
2004	14.75%	5.02%	41.06%	8.98%
2003	3.81%	4.76%	40.78%	7.08%
2002	-5.41%	5.36%	18.25%	2.83%
2001	-5.36%	5.77%	-3.32%	-0.48%
2000	10.19%	6.78%	-8.13%	-1.05%
1999	10.73%	6.40%	3.60%	0.39%
1998	14.73%	6.01%	25.17%	2.27%
1997	18.00%	7.10%	32.25%	2.57%
1996	14.35%	7.19%	48.94%	3.38%
1995	15.89%	7.32%	71.33%	4.23%
1994	2.61%	7.84%	73.70%	4.02%
1993	14.16%	6.62%	99.82%	4.72%
1992	11.58%	7.76%	81.23%	3.79%

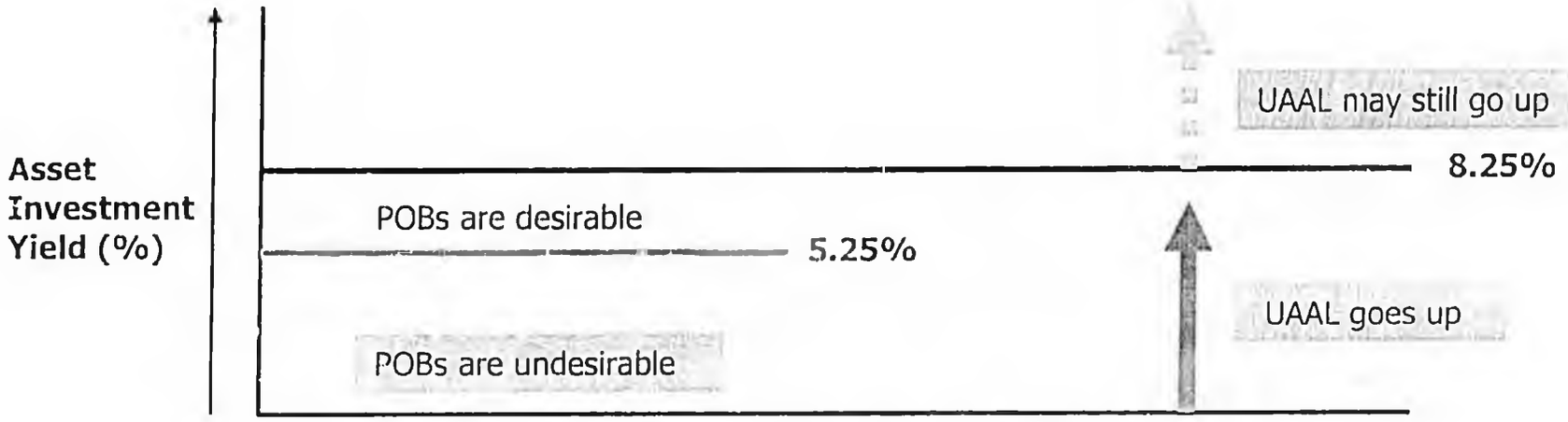
Estimated Cumulative Net Return to 2007 (TRS)



- Based on TRS actual investment history, we can see what the cumulative net return to 2007 might have been if POBs had been issued in any given year.
- For 14 out of 16 years the issuance of POBs would have resulted in a gain to the pension system.

UAAL vs. POB Financial Success

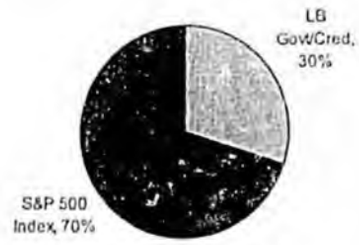
- POB financing:
  - As long as those bond-funded assets earn > 5.25%, we are better off for having borrowed.
  - POB financing is undesirable if assets earn < 5.25%.
- All other things equal, when PERS and TRS assets earn < 8.25%, the UAAL goes up.
- Further, even if those assets earn > 8.25%, the UAAL can increase due to actuarial and / or accounting changes.

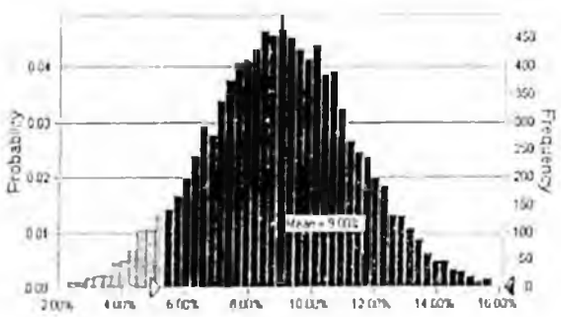


Investment Return Forecast

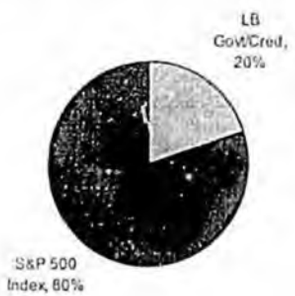
Monte Carlo simulation with 10,000 iterations for each scenario.

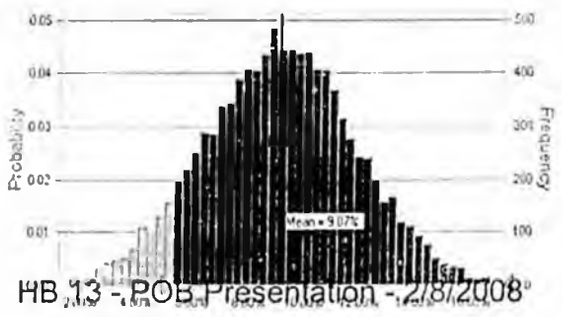
Conservative – 70/30	
Annualized Average Return	9.00%
Stand Deviation of Returns	2.37%
Probability of outperforming 5.25%	94.2%



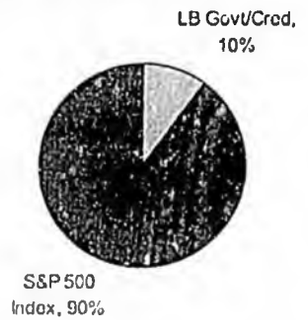


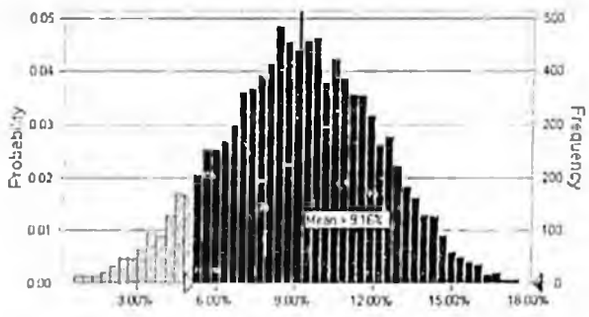
Moderate – 80/20	
Annualized Average Return	9.07%
Stand Deviation of Returns	2.71%
Probability of outperforming 5.25%	92.2%





Aggressive – 90/10	
Annualized Average Return	9.16%
Stand Deviation of Returns	3.03%
Probability of outperforming 5.25%	89.87%





Political Risk – Key Driver of UAAL

Between 1992 and 2003, increasing liabilities – not poor investment performance – caused the most damage to the PERS/TRS system.

- Presented by State Actuary to ARM Board in 2005

Changes in Assets Include:
- Investment performance (i.e. investment risk)

Changes in Liabilities Include:
- Health benefits cost experience
- Health assumption changes
- Plan changes
- Demographic experience
- Non-health changes

Drivers of PERS/TRS Funding Ratio Changes (1992-2003)

	PERS Change in Funded Status	TRS Change in Funded Status
Change Due to Assets	[illegible]	[illegible]
Change Due to Liabilities	-18.5%	-26.6%
Total Change in Funded Status	-22.3%	-29.3%

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Political Risk

High amount of POBs proceeds may cause the pension system to be over-funded, which could lead to political pressure calling for benefit increases that incur new liabilities in the future.

Risk Control:

- POBs are not issued for the full UAAL; a funded ratio of 70-80% is an industry standard.
- Manage pension benefits and UAAL with discipline.

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Market Risk

POBs proceeds cause a large amount of capital infusion into the pension system at once. Prudent investment of the proceeds in early years is critical.

Risk Control:

- Thorough market assessment before POB issuance;
- Considering whether to have a special investment allocation strategy for the proceeds, or stick with the traditional allocations.

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Types of Public Debt

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.
- **HB13 Restriction**
  Please note that HB13 Sec. 37.15.900(b) indicates that "The bonds do not constitute a general obligation of the state."

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Potential Savings

POBs and Cash Infusion

Pay partial UAAL off with cash and borrow partial at 5.25% 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)	$ - 0%	$ 1.0 18%	$ 2.0 36%	$ 3.0 55%	$ 4.0 73%	$ 5.0 91%	$ 5.5 100%
$ -	35.22%	34.07%	32.91%	31.76%	30.61%	29.46%	28.88%
$ 1.0	29.51%	28.36%	27.20%	26.05%	24.90%	23.74%	
$ 2.0	23.80%	22.64%	21.49%	20.34%	19.19%		
$ 3.0	18.08%	16.93%	15.78%	14.63%			
$ 4.0	12.37%	11.22%	10.07%				
$ 5.0	6.66%	5.51%					
$ 5.0	6.66%	5.51%					
$ 5.5	3.80%						

Savings on Annual Contribution Amount (in millions)

POBs (in billions)

Cash (in billions)	$ - 0%	$ 1.0 18%	$ 2.0 36%	$ 3.0 55%	$ 4.0 73%	$ 5.0 91%	$ 5.5 100%
$ -	$0.00	$19.31	$38.62	$57.93	$77.24	$96.55	$106.20
$ 1.0	$95.69	$115.00	$134.31	$153.61	$172.92	$192.23	
$ 2.0	$191.37	$210.68	$229.99	$249.30	$268.61		
$ 3.0	$287.06	$306.37	$325.68	$344.99			
$ 4.0	$382.75	$402.06	$421.37				
$ 5.0	$478.44	$497.75					
$ 5.5	$526.28						

Savings on Employer Contribution Rates

POBs (in billions)

Cash (in billions)	$ - 0%	$ 1.0 18%	$ 2.0 36%	$ 3.0 55%	$ 4.0 73%	$ 5.0 91%	$ 5.5 100%
$ -	0.00%	1.15%	2.31%	3.46%	4.61%	5.76%	6.34%
$ 1.0	5.71%	6.86%	8.02%	9.17%	10.32%	11.48%	
$ 2.0	11.42%	12.58%	13.73%	14.88%	16.03%		
$ 3.0	17.14%	18.29%	19.44%	20.59%			
$ 4.0	22.85%	24.00%	25.15%				
$ 5.0	28.56%	29.71%					
$ 5.5	31.42%						

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

POBs (in billions)

Cash (in billions)	$ - 0%	$ 1.0 18%	$ 2.0 36%	$ 3.0 55%	$ 4.0 73%	$ 5.0 91%	$ 5.5 100%
$ -	$0.00	$272.14	$544.28	$816.43	$1,088.57	$1,360.71	$1,496.78
$ 1.0	$1,348.61	$1,620.75	$1,892.90	$2,165.04	$2,437.18	$2,709.32	
$ 2.0	$2,697.22	$2,969.37	$3,241.51	$3,513.65	$3,785.79		
$ 3.0	$4,045.84	$4,317.98	$4,590.12	$4,862.26			
$ 4.0	$5,394.45	$5,666.59	$5,938.73				
$ 5.0	$6,743.06	$7,015.20					
$ 5.5	$7,417.37						

1. $2.0 billion POBs issued in 2008
2. Assumed $5.5 billion PERS UAAL in 2007
3. Annual employer contribution amount for Tiers I, II, and III would be $590 million without POBs starting in 2007
4. Funding ratio will be improved from 65.12% to 77.81% (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)	$ -	$ 1.0	$ 1.5	$ 2.0	$ 2.5	$ 3.0	$ 3.1
	0%	32%	48%	65%	81%	97%	100%
$ -	44.17%	40.36%	38.45%	36.55%	34.64%	32.74%	32.36%
$ 0.5	36.23%	32.42%	30.51%	28.60%	26.70%	24.79%	
$ 1.0	28.28%	24.47%	22.57%	20.66%	18.75%		
$ 1.5	20.34%	16.53%	14.62%	12.72%			
$ 2.0	12.39%	8.58%	6.68%				
$ 2.5	4.45%	0.64%					

Savings on Annual Contribution Amount (in millions)

POBs (in billions)

Cash (in billions)	$ -	$ 1.0	$ 1.5	$ 2.0	$ 2.5	$ 3.0	$ 3.1
	0%	32%	48%	65%	81%	97%	100%
$ -	$0.00	$22.95	$34.42	$45.89	$57.37	$68.84	$71.13
$ 0.5	$47.84	$70.79	$82.26	$93.74	$105.21	$116.68	
$ 1.0	$95.69	$118.63	$130.11	$141.58	$153.05		
$ 1.5	$143.53	$166.48	$177.95	$189.42			
$ 2.0	$191.37	$214.32	$225.79				
$ 2.5	$239.22	$262.16					

Savings on Employer Contribution Rates

POBs (in billions)

Cash (in billions)	$ -	$ 1.0	$ 1.5	$ 2.0	$ 2.5	$ 3.0	$ 3.1
	0%	32%	48%	65%	81%	97%	100%
$ -	0.00%	3.81%	5.72%	7.62%	9.53%	11.43%	11.81%
$ 0.5	7.94%	11.75%	13.66%	15.57%	17.47%	19.38%	
$ 1.0	15.69%	19.70%	21.60%	23.51%	25.42%		
$ 1.5	23.83%	27.64%	29.55%	31.45%			
$ 2.0	31.78%	35.59%	37.49%				
$ 2.5	39.72%	43.53%					

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

POBs (in billions)

Cash (in billions)	$ -	$ 1.0	$ 1.5	$ 2.0	$ 2.5	$ 3.0	$ 3.1
	0%	32%	48%	65%	81%	97%	100%
$ -	$0.00	$323.41	$485.11	$646.82	$808.52	$970.23	$1,002.57
$ 0.5	$674.31	$997.72	$1,159.42	$1,321.12	$1,482.83	$1,644.53	
$ 1.0	$1,348.61	$1,672.02	$1,833.73	$1,995.43	$2,157.13		
$ 1.5	$2,022.92	$2,346.33	$2,508.03	$2,669.74			
$ 2.0	$2,697.22	$3,020.63	$3,182.34				
$ 2.5	$3,371.53	$3,694.94					

1. $0.5 billion cash infusion and no POBs issued in 2008
2. Assumed $3.1 billion TRS UAAL in 2007
3. Annual employer contribution amount for Tiers I, II, and III would be $266 million without cash infusion and POBs starting in 2007
4. Funding ratio will be improved from 59.9% to 66.36% (based on preliminary $4.63 billion TRS asset as of Dec 31, 2006)

Tax Issues

Taxable Bonds vs. Tax Exempt 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.

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Take-aways

Take-aways

1. If we can earn more than the cost of POB, we are better off for issuing it.
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.

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Q & A

ALASKA'S FUNDING LEVEL FOR its pension system—at 74% in 2006—is below the national average, but that is a major jump from the state's 64% funding level in 2005. Alaska is one of just a few states to have funded retiree health and other non-pension benefits as part of its pension system. Its long-term liability of $3.4 billion for retiree health benefits was 65% funded as of 2005. Alaska started pre-funding its retiree health costs in the 1970s and was one of only three states in 2006 to have set aside enough to cover more than 50% of its liability. Alaska is one of seven states in which neither teachers nor state employees participate in the U.S. Social Security system.

PENSIONS

TOTAL BILL COMING DUE:	$13 billion [1]
FUNDS SET ASIDE:	$9.7 billion
PORTION UNFUNDED:	$3.3 billion
PERCENT FUNDED:	74 as of 2006 [2]
TEN YEAR FUNDING HIGH:	104% in 1999
TEN YEAR FUNDING LOW:	64% in 2005
HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?	

assumptions. Alaska assumes a somewhat higher rate of interest for its pension investments (8.25%) than the 50-state median (8%). As with most states, it uses a five-year smoothing period to calculate the actuarial value of assets. The concentration period conforms to the accounting standards.

1 Pension funds include public and judicial employees, teachers and troopers; state legislators do not participate.

2 50-state median was 84%.

OTHER BENEFITS

TOTAL BILL COMING DUE:	$3.4 billion
FUNDS SET ASIDE:	$2.2 billion
PORTION UNFUNDED:	$1.2 billion [1]
PERCENT FUNDED:	65 as of 2005 [2]
HOW IS THE STATE DOING IN MANAGING THIS BILL?	

1 131% of covered payroll, compared to a total of [illegible] at 135%.

2 Alaska is one of only three states that has set aside more than 50% of its non-pension liabilities.

REFORMS: To stem unfunded pension costs, Alaska passed legislation in 2005 to place employees hired after July 1, 2006, in a defined contribution plan rather than a defined benefit plan. At the same time, the state stopped promising retiree health coverage for new employees during the period prior to Medicare eligibility. It also changed the governance structure for its pension systems, establishing the Alaska Retirement Management Board in the state Department of Revenue.

[illegible]

This fact sheet stems from a 50-state analysis of states' retiree benefit obligations by Pew's Center on the States. The full report and 50 state fact sheets can be found at www.pewcenteronthestates.org.

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CALIFORNIA HAS A LONG-TERM RECORD of solidly funding its pension system, so its concerns about retirement benefit costs for public sector employees are largely focused on health care and other non-pension benefits—and with good reason. California faces a long-term liability of $48 billion for retiree health care for its public workers—an amount second only to New York's in size—but it is one of the five largest states in the country that has not put aside any money for this bill. The state legislative analyst's office has been active in following this issue in California and nationally; see www.lao.ca.gov/retireehealth.

PENSIONS

TOTAL BILL COMING DUE:	$355.5 billion [1]
FUNDS SET ASIDE:	$309 billion
PORTION UNFUNDED:	$46.5 billion
PERCENT FUNDED:	87 as of 2005 [2]
TEN YEAR FUNDING HIGH:	118% in 1999
TEN YEAR FUNDING LOW:	84% in 2003

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?

[redacted]

[redacted]

1 [redacted]

2 [redacted]

OTHER BENEFITS

TOTAL BILL COMING DUE:	$48 billion
FUNDS SET ASIDE:	$0
PORTION UNFUNDED:	$48 billion [1]
PERCENT FUNDED:	0 as of 2006

HOW IS THE STATE DOING IN MANAGING THIS BILL?

1 [redacted]

REFORMS: The legislature has taken several steps in recent years to close pension system loopholes. The California Public Employees' Retirement System also has set up a trust fund so that local employers that contract with the state can pre fund obligations in a qualified trust. Governor Schwarzenegger has convened a special commission to examine public employee pension and retiree health benefits. The commission has been asked to recommend a plan to the legislature by January 1, 2009.

KEY [redacted]

This fact sheet stems from a 50-state analysis of states' retiree benefit obligations by Pew's Center on the States. The full report and 50 state fact sheets can be found at www.pewcenteronthestates.org

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CONNECTICUT HAS DOUBLE THE TROUBLE of most states: a severely underfunded pension system and some of the steepest bills in the country coming due for retirement health and other non-pension benefits. The state funded its pension bill at 100% in 2006, but has often fallen short of funding its whole annual contribution. The state's actuaries have calculated the non-pension bill at $21.7 billion—a figure that does not include benefits for teachers. No money has been set aside yet for this liability, which amounts to about $6,186 per capita, based on the population of the state. That figure is larger than that faced by any other state and far higher than the $774 median for the country. Non-pension benefits for state employees are based on labor negotiations that occurred in the late 1990s—an agreement that is in place until 2017, according to the Connecticut comptroller's office. To move toward full funding of this obligation, the state's annual contribution would be $1.6 billion—four times more than the $393 million in non-pension benefits that it paid for current retirees in 2006.

PENSIONS

TOTAL BILL COMING DUE:	$34 billion [1]
FUNDS SET ASIDE:	$19 billion
PORTION UNFUNDED:	$15 billion
PERCENT FUNDED:	56 as of 2006 [2]
TEN YEAR FUNDING HIGH:	72% in 2001
TEN YEAR FUNDING LOW:	56% in 2006

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?

ASSUMPTIONS: Connecticut assumed 8.5% on its pension investments in 2006, compared to the 8% median for the 50 states. But its 5% inflation assumption for the public employee pension was also high relative to other states—which means the "real rate of return" its actuaries expect is on the lower side. It uses a five-year smoothing period to calculate the actuarial value of assets, similar to the majority of states. The amortization period conforms to accounting standards.

1 Pension bonds included; state and public employees and teachers.

2 60% on actuarial value of assets.

OTHER BENEFITS

TOTAL BILL COMING DUE:	$21.7 billion
FUNDS SET ASIDE:	$0
PORTION UNFUNDED:	$21.7 billion [1]
PERCENT FUNDED:	0 as of 2006

HOW IS THE STATE DOING IN MANAGING THIS BILL?

1 690% of covered payroll, compared to a national median of 135%.

REFORMS: Connecticut is working on improving the funding situation of its very underfunded teachers' pension plan. The General Assembly authorized $2 billion in pension obligation bonds in 2007, and appropriated an additional $300 million for the fund for fiscal years 2008 and 2009. It also committed the state to making its annual required contribution to the teachers' fund while the bonds are outstanding.

KEY: Top Performer; Needs Improvement; Bottom Pot; Has Pension Benefits and Material

This fact sheet stems from a 50-state analysis of states' retiree benefit obligations by Pew's Center on the States. The full report and 50 state fact sheets can be found at www.pewcenteronthestates.org.

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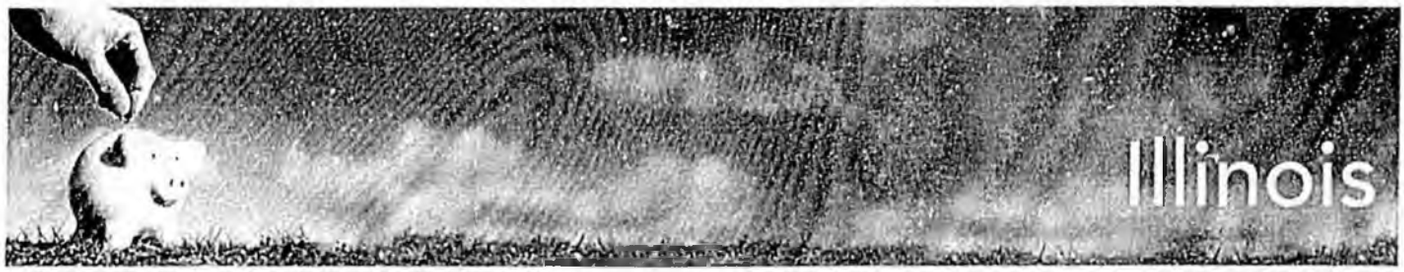

ILLINOIS HAS DOUBLE THE TROUBLE of most states: a severely underfunded pension system and some of the steepest bills in the country for retiree health care benefits. On the pension side, Illinois has one of the poorest-funded systems in the country. While the state has made a number of reforms, it still is underfunding its annual contributions. On an aggregate basis, the state contributed only about 44% of what its own actuaries deemed necessary in 2005, and only 33% in 2006. Illinois' precarious finances will be further aggravated by what is likely to be a significant liability for non-pension benefits. Illinois offers substantial retiree health benefits to public sector employees, and while the state has not yet determined the long-term cost of doing so (officials say an actuarial valuation is now in progress), the Civic Committee of the Commercial Club of Chicago has estimated the price tag for state employees at $48 billion.

PENSIONS

TOTAL BILL COMING DUE:	$103 billion [1]
FUNDS SET ASIDE:	$62 billion
PORTION UNFUNDED:	$41 billion
PERCENT FUNDED:	60 as of 2006 [2]
TEN YEAR FUNDING HIGH:	75% in 2000
TEN YEAR FUNDING LOW:	49% in 2003
HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?	

ASSUMPTIONS: Illinois' three largest funds assume 8.5% interest on pension investments compared to a 50 state median of 8%. It's one of a handful of states that values its assets on a fair market basis rather than smoothing out gains and losses over time. This means that a downturn or upswing in the stock market will be reflected in its pension funding levels immediately. As of 2006, Illinois was using a 40 year amortization period, which does not conform to accounting standards. (The Governmental Accounting Standards Board establishes the time used to amortize pension benefits as 30 years or less.)

1 Pension funds include state employees, judges, the general assembly, teachers and state universities.

2 50 state mean was 82%.

OTHER BENEFITS

TOTAL BILL COMING DUE:	$48 billion [1]
FUNDS SET ASIDE:	$0
PORTION UNFUNDED:	$48 billion [2]
PERCENT FUNDED:	0 as of 2006
HOW IS THE STATE DOING IN MANAGING THIS BILL?	

1 Estimated, for state employees.

2 Estimated, 76% of covered payroll, compared to a national median of 13%.

REFORMS: Illinois established a pension stabilization fund in 2006; it also has enacted a series of offers to encourage employees to opt out of the retirement system in exchange for a lump sum payment. Legislation in the last several years has targeted salary "spiking," changing the way that employees calculate the final salary on which their pension is based. In addition, the state has required that school districts and universities provide partial funding to the pension system for any salary hikes for their employees that exceed 6% and would affect the final salary calculation on which pension benefits are based. In 2003, the legislature authorized the use of $10 billion in pension obligation bonds, which helped move the state from about a 49% funding level in 2003 to a 64% funding level in 2004.

KEY:

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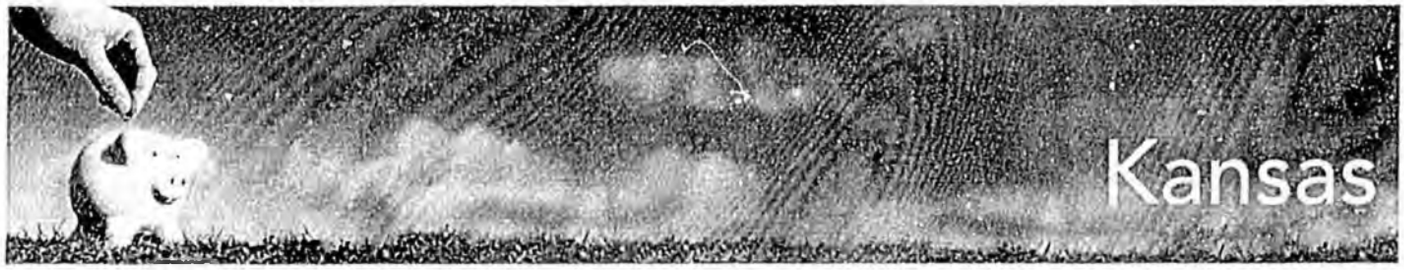

KANSAS IS LAGGING BEHIND many other states when it comes to managing its long-term bill coming due for pensions. The state has fallen short of meeting its annual payments toward its long-term pension obligation for each of the last 10 years. In the last several years, Kansas' payments have dropped to a little less than 70% of what the state's own actuaries say is needed to keep up, hitting a low of 63% of the required contribution in 2006. Kansas has undertaken significant pension reform in the last year, however. On the non-pensions side, Kansas is one of seven states that had not completed its actuarial valuation of the long-term costs of retiree health benefits at the time of Pew's report. But the liability likely will be small relative to that of other states. Kansas does not offer a cash subsidy, but only the "implicit subsidy" that comes from including retirees and typically healthier active employees in the same health plan.

PENSIONS

TOTAL BILL COMING DUE:	$17.6 billion [1]
FUNDS SET ASIDE:	$12.2 billion
PORTION UNFUNDED:	$5.4 billion
PERCENT FUNDED:	69 as of 2006 [2]
TEN YEAR FUNDING HIGH:	88% in 2000
TEN YEAR FUNDING LOW:	68.8% in 2005

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?

ASSUMPTIONS: Kansas assumed an 8% return for its pension investments as of 2006, which is the 50-state median. It uses a five-year smoothing period to determine the actuarial value of assets, also the most common approach. As of 2006, it used a 40-year amortization period for its pension system, which does not conform to accounting standards. The Governmental Accounting Standards Board has set 30 years or less as the appropriate length of time.

1 Public employees retirement system, a trusted fund.

2 50-state median was 82%.

OTHER BENEFITS

TOTAL BILL COMING DUE:	Not available [1]
FUNDS SET ASIDE:	$0
PORTION UNFUNDED:	Not available
PERCENT FUNDED:	0 as of 2006

HOW IS THE STATE DOING IN MANAGING THIS BILL?

1 Kansas' actuarial valuation was not completed at the time of Pew's report, but the liability is likely to be small.

REFORMS: Kansas enacted significant pension reforms in 2007, creating a new defined benefit plan for state, school and local employees hired after July 1, 2009. The new plan will have stricter age and service requirements for receiving benefits, it also will change the method of calculating the final salary that's used in determining pension benefits so that five years are included in the calculation instead of three—a way that states try to control salary "spiking." According to the National Conference of State Legislatures, an unusual feature of the reform is that future costs of the new plan are to be equally shared by employees and employers. The new plan stipulates that government contributions will be at actuarial levels and will not be less than the employee contribution.

KEY: [illegible]

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NEW JERSEY HAS DONE AN ABYSMAL JOB of keeping up with annual funding requirements for its pension system. And when it comes to retiree health benefits, the state faces bills coming due of nearly $22 billion just for state employees, and another $36.5 billion for teachers. (Only some states have calculated the latter; in many, the liability for teachers will appear at the local school district level.) Although New Jersey's pensions, in the aggregate, are only slightly less well funded than the 50-state mean, the system has suffered from a number of problems. The state recently passed several reforms designed to improve its performance and provide better and clearer public disclosure of the inner workings of the pension systems. On the non-pension side, retiree health benefit costs are substantial and growing far faster than the rest of the state budget.

PENSIONS

TOTAL BILL COMING DUE:	$109.6 billion [1]
FUNDS SET ASIDE:	$86.5 billion
PORTION UNFUNDED:	$23.1 billion
PERCENT FUNDED:	79 as of 2006 [2]
TEN YEAR FUNDING HIGH:	111% in 2000
TEN YEAR FUNDING LOW:	79% in 2006
HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?	

ASSUMPTIONS: New Jersey assumes 8.25% interest on its pension investments (compared with a 50 state median of 8%). It uses a five year smoothing period, similar to most states. The amortization period conforms to accounting standards.

1 Pension funds include public employees, teachers, state judicial, state police and police and fire employees.

2 50 state mean was 85%.

OTHER BENEFITS

TOTAL BILL COMING DUE:	$21.6 billion [1]
FUNDS SET ASIDE:	$0
PORTION UNFUNDED:	$21.6 billion [2]
PERCENT FUNDED:	0 as of 2006
HOW IS THE STATE DOING IN MANAGING THIS BILL?	

1 With another $36.5 billion for teachers.

2 3.33% of covered payroll, compared to a national median of 13%.

REFORMS: In 2007 the legislature established a defined contribution plan, in place of the traditional defined benefit plan, for newly elected and some appointed officials, and prohibited professional service contractors from being part of the state's pension system as of January 1, 2008. In addition, state policy makers approved a 10% increase in contributions for some of its public employees, teachers and defined contribution plans. Pension contributions for wages over the maximum wage contribution mark for Social Security will be shifted to a defined contribution plan.

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Oregon

OREGON CURRENTLY HAS THE BEST-FUNDED pension system in the country, and it is one of just six states on track to fund its modest retiree health benefits as well. On the pension side, Oregon's strong performance is partially due to the state's use of bonds to finance its liabilities following a significant drop in pension funding levels in 2002. The state also substantially reorganized its pension system in 2003, shifting to a hybrid plan that has both defined contribution and defined benefit elements. Oregon's non-pension, retiree health benefits are extremely modest, but the state was on track to fully fund those obligations at the end of fiscal year 2006. (In fact, it was one of only 13 states with any assets set aside for non-pension benefits as of 2006.) If Oregon continues on this path, its total non-pension liability will be reduced from $832 million to $238 million, based on the higher interest rate the state can assume if it consistently sets funding aside in an irrevocable qualified trust.

PENSIONS

TOTAL BILL COMING DUE:	$51.2 billion [1]
FUNDS SET ASIDE:	$56.6 billion
PORTION UNFUNDED:	$0
PERCENT FUNDED:	110 as of 2006 [2]
TEN YEAR FUNDING HIGH:	110% in 2006
TEN YEAR FUNDING LOW:	91% in 2002

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?

Assumed rate: Oregon assumes 8% investment returns, which is the 50-state mean. It's one of a handful of states that values its assets on a fair market basis rather than smoothing out gains and losses over time. This means that a downturn or upswing in the stock market will be reflected in its pension funding levels immediately (as occurred in 2002 when the pension funding level dropped to 91% from 106.7% the previous year).

1 Consolidated public employees retirement fund.

2 50-state mean was 85%.

OTHER BENEFITS

TOTAL BILL COMING DUE:	$832 million [1]
FUNDS SET ASIDE:	$187 million
PORTION UNFUNDED:	$645 million [2]
PERCENT FUNDED:	22 as of 2006

HOW IS THE STATE DOING IN MANAGING THIS BILL?

1 About $415 million for state employees.

2 % of covered payroll, compared to a national median of 12%.

REFORMS: Oregon significantly reorganized its pension systems in 2003, with a hybrid defined contribution/defined benefit plan put in place that the state believes has resulted in substantial savings. The state also restructured the retirement system board at the time and instituted a number of changes to its actuarial practices.

KEY: Top Performer; Good, Improvement; Behind; High Pension Benefits and Modest

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Washington

WASHINGTON HAS GENERALLY KEPT a careful eye on the health of its many pension plans, which are well funded on an aggregate basis. The state also has moved quickly to resolve potential problems. For example, the legislature suspended contributions to several large closed pension funds in the 2003-2005 biennium and planned to do so again in 2005-2007, but the 2006 supplemental budget included $350 million for a pension stabilization account that helps position the state to recover from past missed payments. Additional funding has brought that account to $448 million. Retiree health benefits are moderate. So far, the state has chosen not to set aside any retiree health funding for the future, but is trying to use management reforms to lower growth in health costs.

PENSIONS

TOTAL BILL COMING DUE:	$48.1 billion [1]
FUNDS SET ASIDE:	$47.9 billion
PORTION UNFUNDED:	$201 million
PERCENT FUNDED:	99.58% as of 2006 [2]
TEN YEAR FUNDING HIGH:	124% in 2000
TEN YEAR FUNDING LOW:	96% in 2005

HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?

ASSUMPTIONS: Washington assumed an 8% return on its pension investments, the same as the 50-state median in 2006. It uses an eight year graded smoothing period for most of its pension funds, which would tend to mute the immediate impact of sudden drops or upswings in investments. Washington has used the aggregate cost method for its pension calculations for several large funds, which doesn't provide a funding ratio, but this information is available in the pension systems' actuarial valuation. The amortization period conforms to accounting standards.

1 Pew's figure includes public school employees, troopers, law enforcement and state patrol, judicial employees and volunteer firefighters.

2 50-state median was 82% as of December 2007.

OTHER BENEFITS

TOTAL BILL COMING DUE:	$3.8 billion [1]
FUNDS SET ASIDE:	$0
PORTION UNFUNDED:	$3.8 billion [2]
PERCENT FUNDED:	0 as of 2006

HOW IS THE STATE DOING IN MANAGING THIS BILL?

1 For state employees; an additional $3.3 billion was calculated for teachers.

2 For state employees; 70% of covered payroll, compared to a national median of 135%.

REFORMS: In 2007, Washington created gain sharing for teachers and public employees, which provided that half of investment returns exceeding 10% went to additional pension benefits for members. While popular with employees, gain sharing can be tough on a pension fund's fiscal health since it means that states can take a hit from poor investment returns but cannot fully make up prior losses when investments rise. The state offset the repeal of gain sharing with some benefit enhancements. In addition to setting up a pension stabilization fund, Washington earlier in the decade created an optional hybrid plan for state and local employees. In terms of non-pension benefits, Washington pays an implicit health subsidy prior to Medicare eligibility, allowing retirees to sign on to the same plan as employees. It also provides a modest cash subsidy for Medicare eligible retirees. Officials say that in 2007, the state's management of its health care had limited the rate of cost to 3.4%.

KEY: Top Performer; Above Average; Below Par; Poor Performer

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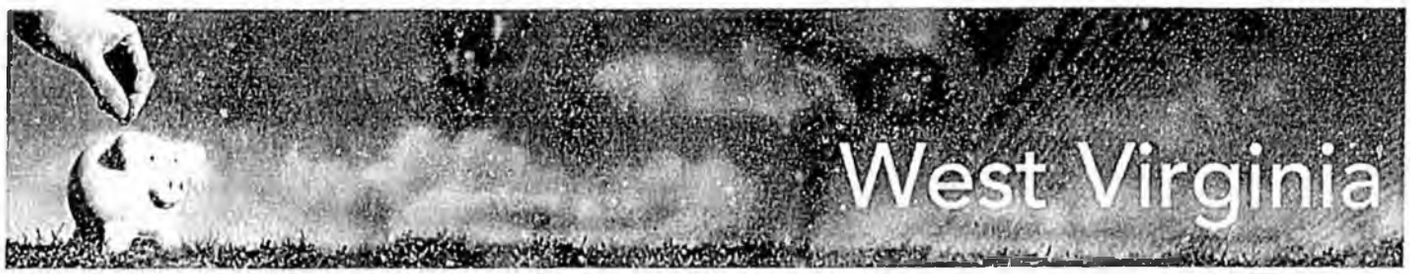
This fact sheet was revised January 30, 2008.



WHEN IT COMES TO PENSION FUNDING LEVELS, West Virginia—with about 55% of its aggregate pension obligations covered—lags behind every other state. Just four years ago, however, the situation looked much worse. In recent years, West Virginia stands out for responsibly funding its annual required contribution to its pension plans. It also was one of the speediest states in taking action to reduce its sizeable liability for non-pension benefits—mostly retiree health care. The state, along with a dozen others, established an irrevocable trust in 2007 in which to set aside assets for funding those benefits. It also increased co-payments for retirees and reduced costs by requiring that most retirees participate in a Medicare advantage prescription drug program. West Virginia's intention to at least partially fund its non-pension benefits, along with aggressive cost-containment efforts, resulted in a significant drop in the state's long-term bill—from $7.8 billion in the initial valuation to $3.4 billion in a subsequent valuation in April 2007.

PENSIONS

TOTAL BILL COMING DUE:	$11.8 billion [1]
FUNDS SET ASIDE:	$6.5 billion
PORTION UNFUNDED:	$5.3 billion
PERCENT FUNDED:	55 as of 2006 [2]
TEN YEAR FUNDING HIGH:	55% in 2006
TEN YEAR FUNDING LOW:	39% in 2003
HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?	

ASSUMPTIONS: West Virginia assumed an investment return of 7.5% as of 2006, below the 50 state median of 8%. It's one of a handful of states that values its assets on a fair market basis rather than smoothing out gains and losses over time. This means that a downturn or upswing in the stock market will be reflected in its pension funding levels immediately. The amortization period conforms to accounting standards.

1 Pension funds include public employees, teachers, public safety and [illegible] personnel, state police and judges.

2 [illegible] state's [illegible]

OTHER BENEFITS

TOTAL BILL COMING DUE:	$3.4 billion [1]
FUNDS SET ASIDE:	$0
PORTION UNFUNDED:	$3.4 billion [2]
PERCENT FUNDED:	0 as of 2006
HOW IS THE STATE DOING IN MANAGING THIS BILL?	

1 As of April 2007; $7.8 billion in the original actuarial valuation.

2 As of 2006; $39 million was deposited in a trust in 2007, with another deposit expected by year's end.

REFORMS: In 2005, the West Virginia legislature closed its defined contribution plan for teachers and reopened the Teachers Retirement System defined benefit plan that had been shut down in 1991. (The legislation that consolidated the two plans was subsequently ruled unconstitutional by the Kanawha County Circuit Court and the decision is being appealed, according to the National Conference of State Legislatures.) In 2005, voters rejected Governor Manchin's plan to repair the state's poorly funded retirement system by selling $5.5 billion in bonds. In 2007, the state set up an irrevocable trust for its non-pension benefits.

[illegible] [illegible] [illegible] [illegible]

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WISCONSIN STANDS OUT in how it has managed the bill coming due for its public sector pension obligations. In fact, the state's pension system has had a remarkably steady ride over the last 10 years. Wisconsin has an excellent record of making its full annual required contribution. It issued $729 million in pension bonds in 2003, and at that time became the first state to issue bonds for non-pension benefits as well, to the tune of $600 million. This makes it the only state in the country that has just about fully funded these liabilities. This is not as tall an order as in many states, because the benefits are very modest. Wisconsin's long-term retiree health care costs stem from a subsidy that allows retirees to participate in the same plan as younger and healthier active employees. It also allows unused sick leave of departing employees to be converted to health care accounts.

PENSIONS

TOTAL BILL COMING DUE:	$73.7 billion [1]
FUNDS SET ASIDE:	$73.4 billion
PORTION UNFUNDED:	$320 million
PERCENT FUNDED:	99.6 as of 2006 [2]
TEN YEAR FUNDING HIGH:	99.6% in 2006
TEN YEAR FUNDING LOW:	95% in 1997
HOW IS THE STATE DOING IN PAYING ITS ANNUAL BILL?	

ASSUMPTIONS: Wisconsin assumed 7.8% interest on its pension investments as of 2006, slightly under the 50-state median of 8%. It uses a five-year smoothing period, similar to the majority of the states. The amortization period conforms to accounting standards.

1 Wisconsin Retirement System

2 50-state median was 92%

OTHER BENEFITS

TOTAL BILL COMING DUE:	$1.823 billion
FUNDS SET ASIDE:	$1.806 billion
PORTION UNFUNDED:	$17 million [1]
PERCENT FUNDED:	99 as of 2006 [2]
HOW IS THE STATE DOING IN MANAGING THIS BILL?	

1 Less than half a percent of covered payroll, compared to a national median of 135%.

2 Wisconsin had the highest funding ratio for its pension benefits as of 2006, due to its decision to fund out much of its modest obligation. Only 12 other states had any assets at all set aside at this time.

REFORMS: Wisconsin has not had substantial pension reform in recent years. The biggest news was its 2003 bond issuance to help keep up with pension and retiree health liabilities (see above). In 2005, the state transferred responsibilities of the Legislature's Retirement Research Committee to the Legislative Council. Every two years it produces an excellent report comparing pension systems in the 50 states; the new one is due out in December 2007.

KEY: Top Performers | Needs Improvement | Below Par | Best Pension Funded State Median

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State of Alaska
ALASKA RETIREMENT MANAGEMENT BOARD
Relating to Pension Obligation Bonds

Resolution 2007-17

WHEREAS, the Alaska Retirement Management Board (Board) was established by law to serve as trustee to the assets of the State's retirement systems; and

WHEREAS, the State of Alaska and its political subdivisions participate in the retirement systems as a matte of law and through participation agreements and pursuant to those provisions public employer contribution rates are set by the Board based on information including actuarial assumptions and calculations of unfunded accrued actuarial liability; and

WHEREAS, Chapter 9 FSSLA 2005 (SB 141) enacted changes to the retirement systems and among other things required the Board to provide reports to the legislature and make recommendations regarding short term and long term solutions to improve the financial health of the retirement systems; and

WHEREAS, the Board has received information from public employers as well as advisors, consultants, and other experts concerning the potential usefulness of pension obligation bonds ("POB's") to assist public employers in meeting their obligations to the retirement systems and in particular to pay the unfunded accrued actuarial liability of the systems; and

WHEREAS, public employers as well as consultants and experts have represented to the Board certain matters concerning POB's including:

1. POB's have been used to finance liabilities associated with under funded pension plans and under the right circumstances POB's can significantly reduce the cost of financing a pension liability;

2. POB's carry the risk if the pension system earns less on the bond proceeds than the cost of issuance and interest on the bonds, the issuer would incur higher costs than would have been incurred without issuing the bonds; conversely if the system earns higher returns than the cost of capital rising from issuance of the POB's, the public employer issuing the POB's will potentially benefit;

3. Determining success of POB's is a long term proposition because a final assessment is not possible until the POB's are paid off;

4. POB's provide an option for public employers to make higher than normal contributions to the systems and such higher than normal contributions appeal to the Board because the contributions could reduce the unfunded accrued actuarial liability and therefore improve the funded status of the systems;

5. There are certain concerns regarding the ability to invest proceeds of POB's according to the Board's normal asset allocation plans upon receipt of such funds; as such there is a need to assure that an asset allocation specific to the proceeds of particular POB's can be made: a specific allocation and risk profile may be necessary in order to recognize that some asset classes such as real estate may not allow immediate access to quality investments with respect to proceeds contributed through the issuance of POB's;

6. There would be no guarantee of a particular rate of return by the Board with respect to investments of proceeds of POB's; and

WHEREAS, since it is a primary responsibility of the Board to ensure that pension systems are fully funded, POB's may offer an appropriate mechanism if appropriate legislative actions are taken to meaningfully enable issuance of POB's by interested public employers under state law and constitutional provisions.

NOW THEREFORE BE IT RESOLVED BY THE ALASKA RETIREMENT MANAGEMENT BOARD THAT:

1. The Board acknowledges employers participating in the public employees' retirement system, teachers' retirement system, and judicial retirement system should be encouraged to evaluate all feasible options to finance their pension obligations including the use of POB's as such an option;

2. The Board recommends that the legislature undertake appropriate action to enable public employers to access capital markets in the most favorable means possible, with the issuance of POB's being one such potential means of access;

3. The Board believes that POB's constitute a concept worthy of fair and further consideration and supports passage of legislation to allow the issuance of POB's when an employer determines it would be beneficial.

DATED at Juneau, Alaska this 27th day of April, 2007.

Chair

ATTEST:

Secretary

Retired Public Employees of Alaska, APEA/AFT
Anchorage Office
3310 Arctic Blvd., Suite 200, Anchorage, Alaska 99503
Phone (907) 274-1703, (800) 478-9992, Fax 907-277-4588

March 12, 2007

Representative Mike Chenault
Representative Kevin Meyer
Co-Chairs, Finance Committee
Alaska House of Representatives
State Capitol
Juneau, AK 99801-1182

Representatives Chenault and Meyer:

The Retired Public Employees of Alaska represents over 3,000 members that worked hard for Alaskans for decades at the State and local levels of government. Two thirds of our members remain in Alaska and contribute many thousands of volunteer hours and substantial sums of money to the Alaska economy. Our members care about the future of Alaska and many are very actively involved in our communities and in the political process.

We understand that the projected under funding of the Public Employees Retirement System, Teacher Retirement System, Judicial Retirement System and National Guard Retirement System will result in a significant increase in employer contributions for FY-08. RPEA supports the full funding of these costs from State general funds. We ask that you support this approach during your budget deliberations in the upcoming weeks.

There are two bills regarding the retirement system that the Retired Public Employees of Alaska support. We support HB 12 as we believe the projected under funding needs to be paid down on an annual basis. We know there is no "magic" in the 7 year period in the bill, it is a point of departure for discussion. We support HB 13 as it gives municipalities an option to deal with their portion of the under funded obligation.

Please feel free to contact me if you have any questions on RPEA's positions on these issue

Respectfully,

Sam Trivette

Sam Trivette
President

Mike, this helps some!
Hope
Thanks for your help over the last few years.
Sam

cc: Finance Committee Members

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Your Retirement Years

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January 23, 2008

Time May Be Ripe For A POB Revival

Primary Credit Analyst:
Peter Block, Chicago (1) 312-233-7040; peter_block@standardandpoors.com

Secondary Credit Analyst:
Robin Prunty, New York (1) 212-438-2081; robin_prunty@standardandpoors.com

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Time May Be Ripe For A POB Revival

Despite the prospect of increased funding ratios for public pension funds over the next several years, pension obligation bonds (POBs) may reemerge as a key financing tool for unfunded pension liabilities. The key to this reemergence, after a two-year hiatus, will depend upon actual investment performance in 2008 and 2009, the ability of plan sponsors to make actuarially required contributions (ARCs) in light of uncertain economic and revenue conditions, and burgeoning liabilities for other postemployment benefits (OPEB).

According to the National Association of State Retirement Administrators (NASRA) Public Fund Survey of 2007, public pension fund assets returned a healthy 11.9% on average between 2003 and 2006. Given these very strong returns, which are above the average assumed return rate of 8% for most fund assets, Standard & Poor's Ratings Services expects to see increased average pension funding levels over the next several years. However, NASRA reported that the average ratio of the 112 public pension plans in the survey was 86% in 2006. Although the ratio is still relatively strong, it is down significantly from the fully funded status in 2000 and 2001. In general, funding ratios declined due to poor returns in 2001-2002, benefit enhancements, demographic assumption changes, and underpayment of ARCs by several large state sponsors.

We are already beginning to see some POB activity, with Alaska, Connecticut, Puerto Rico, and Kentucky among the states currently contemplating a large POB issuance to bolster funding ratios and reduce costs. West Virginia recently securitized its tobacco settlement revenues and used proceeds to fund its pension plan, although the issue was not a POB in the traditional sense. POBs have been popular with issuers and successful for the sponsors in the 20 years through 2005, but issuance slowed in recent years because of strong investment returns.

Rating Implications

Employers looking to help manage their unfunded liabilities through the issuance of a POB should carefully weigh the pros and cons. It is also important to understand how the POB fits into the overall debt and liability structure of a prospective issuer. There should be a clear POB plan with attainable actuarial and investment assumptions and a conservative structure. Prudent allocation for projected savings over time limits the chances for problems

POBs could have a negative effect on credit quality if they were structured poorly. Standard & Poor's will continue to evaluate POB risks in light of each employer's profile at the time of sale as well as their projected effects over time. POBs may work as planned over the long term, but could cause short-term fiscal dislocations depending upon actual investment returns.

Brief History

Overall, POBs have largely been successful for the sponsors who have used this strategy. In the past 20 years when the vast majority of these bonds were issued, investment yields overall exceeded investment return assumptions of public pension funds and the interest cost of the POBs, generating actuarial gains for the plans. While a few POBs issued in the 1980s, the first big wave of POBs came in the early 1990s. By the end of the decade, about $15 billion of POBs had been issued.

The years 2000 and 2001 were slow for POB issuance because of the strength of U.S. public pension funding,

especially in 2000 when the average funded ratio was slightly over 100%, up from only about 80% in 1990. These robust funding gains were fueled by above-average equity returns during the late 1990s and a general shift in the weighting of public pension assets to higher-yielding equity assets from fixed-income assets.

Beginning in 2003, however, public pension funding ratios fell sharply, exacerbated by a combination of adverse circumstances, including the decrease in pension asset values due to poor equity returns following the dot-com bust in 2001-2002, the increase in liabilities from benefit enhancements put in place during that time, and demographic changes, such as increased member longevity. These factors created the second significant wave of POBs in 2002-2005. As in the first wave, California counties led the pack, and there were a number of repeat borrowers, but there were also significant new players. The state of Illinois, which issued a POB in June of 2004, holds the POB record for sheer size at $10 billion — almost four times larger than the previous record. Oregon, Kansas, and Wisconsin, have completed $1 billion plus POB sales in recent years.

POB Mechanics

Complex financial implications, simple execution

While the financial implications of POBs are complex, the actual mechanics are relatively simple. Generally, the municipal employer will use the findings from the most recent actuarial valuation, or have a new valuation completed, to determine the pension system's unfunded actuarial accrued liability (UAAL). Then, it will decide what portion of the UAAL will be funded with the POB. In the 1990s, most employers funded the entire UAAL, but for various reasons discussed below, many now tend to finance less than the full amount. Once the POB is sized and sold, the net proceeds are placed in the pension trust fund to be commingled with the other funds, and usually invested according to existing asset allocation guidelines. Thus, the pension fund experiences a rapid increase in assets resulting in a higher funded ratio.

For the POB to generate savings for the employer, the investment return rate on the invested POB proceeds must be greater than the interest cost of the bonds (and ideally equal to, or exceed the pension system's investment return assumption), and the larger the spread between these two rates, the better. The employer, as POB issuer and obligor, would then be projected to achieve lower total pension contributions than it would have if it had not sold the POB.

POB Risks

POB issuers face three principal risks:

- Arbitrage;
- Leverage; and
- Political

Arbitrage

POBs are essentially an arbitrage arrangement, the success of which depends on the premise that the pension trust fund assets (including POB proceeds) will earn on average more than the POBs' interest cost, and hopefully the pension plan's assumed investment return rate (generally about 8%) or better each year for the life of the bonds. If the bonds are sold at an interest cost of 6%, for example, the spread could generate savings if the investment return goals are met over the life of the bonds.

If the POB trust fund earns 8% or more on the bond proceeds, the issuer would pay lower pension-related costs (contributions plus POB interest) than without the POB. However, if the investment return is less than the POB interest cost, the transaction becomes a drag on cash flow since an unfunded actuarial accrued liability could reemerge. If returns are above 6% (as in the example above) but below 8%, the employer would have increasing contribution costs, but would have had them even without the POB.

While certain periods, particularly the late 1990s, produced some impressive investment returns, returns can vary dramatically and may or may not average the investment return assumption or even the POB interest rate cost. For this reason, a POB's full effect is only known at the bonds' final maturity. Many POBs have appeared successful for several years, or even a decade, only to have investment gains eroded upon maturity. Conversely, after poor results in the early years, some POBs achieved projected benefits in the final analysis.

In any event, we do know that even if projections are met on average over the life of the POBs, there will be years of higher returns, and some that are lower (maybe significantly), than the investment hurdle. We do not have to look back very far to see evidence of such swings: in fiscal 2001, the S&P 500 index of domestic equities fell 16%; in 2002, it fell 19%, but in 2003, it fell only 1.6%. These market declines hurt issuers with POBs outstanding: most had to pay increased contribution rates to cover the new actuarial losses and they had the higher debt service costs due to issuing the POB.

Leverage

Adding too much leverage is another risk factor for POB issuers. Borrowing for any purpose increases leverage and fixed costs. While the issuer is substituting one type of long-term liability (POB) for another (pension UAAL), there is a difference. In most cases, bond debt service is a "hard" obligation compared with the "softer" contribution payments used to amortize the UAAL. Bond debt service becomes a fixed cost and must be paid in full and on time or the issue falls into default with wide ramifications. Conversely, employers' contribution payments to a pension trust may be temporarily deferred or reduced without serious negative consequences.

However, risks and opportunities are also associated with "softer" obligations. A soft obligation may be deferred during a temporary period of reduced liquidity resulting from a onetime unexpected expenditure or an unexpected dip in revenues. The obligation may be deferred until fiscal balance is restored to bring payment of the obligation back on schedule, resulting in no credit impact. Unfortunately, soft obligations may also be deferred for political expediency, creating significant credit issues if this deferral is practiced over successive periods. A hard obligation could lead to better long-term fiscal stability if political deferrals are a real risk. Regardless of the political climate, the size of the POB relative to the issuer's total debt structure must be measured in terms of the level of debt service that can be managed if actual future investment returns do not meet the original POB plan projections.

Political

POBs can become a political issue if the debt is sold to the public as a complete solution to the government's pension funding problem. For example, if a POB is issued for the full UAAL, resulting in a 100% funded ratio, and subsequent higher-than-average returns push the ratio to 110% or 120%, political pressure could arise to distribute the so-called excess funding by increasing benefits or decreasing contributions. In fact, in a lower-return environment with declining funding levels over the long term, those systems that have taken the bulk of their excess funding out of their POB structure may see trouble ahead. For example, say the POB issuer described above had average annual investment returns of 10% against its investment assumption of 8%. However, instead of permitting the natural increase in the funded ratio that these conditions would have caused, the issuer managed its funding

ratio, through contribution holidays and benefit improvements, to maintain the ratio at around 100%. If investment returns decline, the issuer may have already reaped all its gains from the transaction structure and be headed for actuarial losses. If actuarial losses are incurred, employer and employee contribution rates will likely increase.

Rating Process

The rating of POBs parallels that of long-term debt with similar security but also considers certain additional analytical factors pertinent to the POB and trust fund. POBs issued to date usually have a GO or appropriation pledge. In our analysis of POBs, we focus on the bonds' effect on the issuer's debt structure and the ability to meet obligations. The financial review includes the impact on both the balance sheet and the operating statement or cash flows. The status of the issuer's pension trust fund on a pro forma basis is also part of the review.

From the balance sheet perspective, we look at how the POB fits into the issuer's total debt structure, including a review of future capital requirements that may require bonding, as well as other long-term liabilities. We look at total debt with and without the POB so as not to penalize an issuer in comparison to another issuer that may have relatively low debt (and no POBs) but sizable unfunded liabilities. We also evaluate the leverage added by the POB to determine if the issue markedly increases hard, fixed costs (bond debt service) in place of a softer, more discretionary obligation. We will also seek to determine if subpar investment returns could put upward pressure on pension contribution rates and whether higher contribution rates, coupled with the POB debt service costs, put the issuer's budget under greater strain. The issuer must also be cognizant of the effect a POB issue may have on statutory debt limits or whether the issuance impedes debt issuance for the capital improvement plan.

From a cash flow standpoint, we review projected debt service and contribution costs, with and without the POB, and the validity of the assumptions, including those for POB interest costs and trust fund investment returns to determine how these projections compare in total and annually.

The spread between interest costs and investment return generates the savings expected from the transaction. The issuer must be able to provide details on the following:

- Magnitude of annual savings and total present value savings.
- Where (in what years) are the savings taken?
- Are the savings front-loaded in an attempt to mask budgetary stress?
- Will any front-loading lead to higher, unsustainable contribution rates in later years?
- Do the potential savings from the POB outweigh the risks involved?

The cash flow analysis is critical to understanding the full impact of the transaction. As part of the POB analysis, we also review the status of the pension trust fund, which receives the bond proceeds:

- What is the statutory relationship between the issuer/employer and the pension fund?
- How have the laws and precedents for contributing affected funding progress, and how do they play into the POB strategy?
- What are the funding goals and how will the POB affect these objectives?

Special rating documentation requirements for POBs

The unique nature of POBs calls for certain additional documentation not normally requested for other types of ratings:

- POB financing plan, including its effect on the overall debt plan;
- Projections of UAAL contributions and debt service with and without the POB;
- Latest pension fund annual report,
- Most recent actuarial valuation and experience studies of the fund; and
- Pension fund's current asset allocation strategy and plan for investing POB proceeds.

THE FOLLOWING DOCUMENT

HAS NOT BEEN FILMED BUT IS

AVAILABLE IN THE ORIGINAL FILE

An Introduction to

Pension Obligation Bonds and Other Post-Employment Benefits

Third Edition

ROGER L. DAVIS

ORRICK

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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/OPEB Bond Group and has worked on more than 30 such issues in various states.

Members of Orrick's **Pension Obligation/OPEB Bond Group** are shown on the contact list at the end of this booklet.

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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 have been an increasingly popular and successful 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 340 POB issues by state and local gover[illegible]ers in at least 26 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.

Since the first edition of this pamphlet in 2003, new accounting rule GASB 45 has been promulgated, requiring that other (nonpension) post employment benefits ("OPEB") be accounted for much like pension obligations. This has given rise to intense interest in defining OPEB, calculating the unfunded accrued actuarial OPEB liability, developing a strategy for handling this liability, establishing OPEB trusts in which to make deposits against such liability and the possible use of bonds to fund such deposits. Therefore, the purpose and coverage of this pamphlet has been expanded to provide an introduction to these topics.

The author is chair of the Public Finance Department at Orrick, Herrington & Sutcliffe LLP and has been bond counsel on several dozen POBs in various states.

He has also been in the forefront of establishing OPEB trust and OPEB bond strategies. He is one of the few recognized authorities in these aspects of OPEB. Orrick is the nation's premier public finance/bond counsel firm, ranked number one for more than a decade,[1] with extensive experience in all types of POBs and similar financings.[2]

1 Rankings for securities transactions of various types are performed annually by Thomson [illegible], 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 [illegible] over the last decade, with many more such issues than even 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 (or longer) period.[3] 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").

3 Note that the smoothing methodology referred to may result in "unrealized" or "lagging" unfunded liability. See discussion of POB possibilities in footnote 4. Note also that, in April 2005, CalPERS adopted a new policy that will result in smoothing over 15 years (instead of 3).

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 2, 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% to 8% depending on the particular pension system. When taxable bond rates are low, and as of beginning of 2006 they are roughly 5.45% 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 $6,900,000 on POBs amortized over the same period assuming a 5.45% 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 by the pension fund will be credited to the state or local government issuer either as 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.

One study of POBs in 2004 concluded that 84% were profitable to their issuers. Another 7% were at breakeven, leaving only 9% that have lost money. Even measured as of the least favorable time in the stock market, late 2002, only 34% were money losers, most of which were less than four years old and most of which are now at breakeven or profitable. Virtually all POBs are expected to be profitable over their term.

D. Budget Relief

During periods of substantial budget deficits, POBs are frequently 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, for example, discussion in Appendix C.

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 Appendix B.

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 Appendix C.)

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

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

balanced and prudent investment practices with respect to POB proceeds could expose the sponsor to market losses.

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 typically 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. Now, 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 6).

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, cost 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 auction 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 2005, 28-day insured auction rate taxable POBs bore rates of roughly 3.80% to 4.00% compared to 30 year taxable fixed rates of approximately 5.15%). 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 by various news and information services. 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 accreted, 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 accreted value of the bonds, being the original principal amount plus the amount of accreted, compounded interest up to that

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. Please refer to another of our pamphlets, entitled Interest Rate Swaps: Application to Tax-Exempt Financing (much of which is applicable even though POBs are taxable). 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. 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 or part of certain years contributions to the UAAL. If agreed to by the pension system, the second approach can result in suspension of UAAL contributions during those years (for example, the next succeeding 10 years). At the end of the period, the UAAL will be

5 Depending on state law and financing structure, it may also be possible to finance future years' 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, years).

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. This prohibited anticipated direct benefit from the investment of the bond proceeds in 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 form 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.

CHAPTER EIGHT

Other Post Employment Benefits (OPEB)

There are some other state and local government non-bond obligations, which are like pension obligations and which it may be possible to fund in a manner similar to POBs. The first edition of this pamphlet in 2003 covered primarily POBs, the most frequently used and highly developed of this category. It noted, at least briefly, that there may be other applications of the same concepts. Several examples (not an exhaustive list) include such other actuarially based insurance or benefit obligations as workers compensation, health benefits and unemployment insurance, and such non-actuarial obligations imposed by law as court rendered judgments for damages against state or local governments and, in California, county obligations under the Teeter delinquent property tax program.

In June 2004, the Governmental Accounting Standards Board issued GASB 45 "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions," ushering in intense interest in funding options for OPEB and the logical extension of this pamphlet to cover this emerging topic.

CHAPTER NINE

GASB 45

A. Accounting Change.

OPEB refers to "other post-employment benefits," meaning other than pension benefits. OPEB consist primarily of health care benefits, and may include other benefits such as life insurance, long term care and similar benefits. Until now, these benefits have generally been administered on a pay-as-you-go basis and have not been reported as a liability on municipal financial statements.

GASB 45 will require municipalities to account for OPEB liabilities much like they already account for pension liabilities, generally adopting the actuarial methodologies used for pensions, with adjustments for the different characteristics of OPEB and the fact that most municipalities have not set aside any funds against this liability. Unlike GASB 27, which covers accounting for pensions, GASB 45 does not require municipalities to report a net OPEB obligation at the start.

B. Annual Required Contribution (ARC) and Net OPEB Obligation (NOO).

Under GASB 45, based on an actuarial valuation, an annual required contribution (ARC) is determined for each municipality. The ARC is the sum of (a) the normal cost for the year (the present value of future benefits being earned by current employees) plus (b) amortization of the unfunded actuarial accrued liability (benefits already earned by current and former employees but not yet provided for) (UAAL), using an amortization period of not more than 30 years. If a municipality contributes an amount less than the ARC, a net OPEB obligation (NOO) will result, which is required to be recorded as a liability on its financial statements.

Note that the UAAL will be much greater than the NOO. Although not required to be treated as a liability on financial statements, the UAAL will likely appear in a related footnote and be disclosured in connection with the municipality's bond or note offerings.

Some actuaries have estimated that for many municipalities the ARC may be 5 to 10 times higher than current pay-as-you-go expenses. However, after a period of years, because of factors such as increasing number of retirees and inflation in health care costs, pay-as-you-go costs are expected to far exceed the ARC. GASB 45 does not require that the unfunded liability actually be amortized, only that the municipality account for its unfunded accrued liability and compliance in meeting its ARC.

GASB 45 does not specify the actuarial assumptions to be used in calculating an OPEB liability. Most likely, assumptions will be based on methodology that has developed in connection with FAS 106 (the private sector counterpart to GASB 45 implemented in the early-1990s).

An actuarial valuation is required every 2 years for OPEB plans with more than 200 members, or every 3 years if there are less than 200 members.

C. Effective Date.

Although GASB 45 encourages earlier adoption, implementation is required by the following dates, based on the size of government measured by annual revenues:

Annual Revenue	Effective for Fiscal Years Beginning After:
Greater than $100 million	December 15, 2006
Between $10 million and $100 million	December 15, 2007
Less than $10 million	December 15, 2008

CHAPTER TEN

OPEB OPTIONS

Municipalities have a number of options to consider in developing an OPEB strategy or otherwise addressing their OPEB liability, such as:

A. Reduce OPEB Obligation

Unlike pensions, which municipalities are required to provide to their employees as a matter of law in most states, state law generally does not impose on municipalities the obligation to provide OPEB. Instead, the OPEB obligation usually arises purely by action of the municipality, whether by collective bargaining agreement, MOU, other employee contract, ordinance, resolution, board policy or even just past practices. Many of these are subject to renewal, renegotiation, change or termination. In some cases, municipalities have been careful to describe all of their OPEB obligations as discretionary and/or subject to change or discontinuation. However, while the ability to change or discontinue OPEB for future employees should be an option in most cases, the ability to change or discontinue OPEB with respect to retired or current employees may vary from state to state, depending on the degree to which the courts in a particular state treat OPEB, even if not contractually vested by express contractual terms, as not subject to unilateral change by the municipality on the theory that they are "fundamental benefits", "inducement to remain employed," "elements of compensation contractually vested in accordance with their terms upon acceptance," "earned by remaining employed" or similar theory and on the particular facts pertaining to the municipality, its employees and its OPEB. This is an evolving area of the law, and while it evolves, most municipalities are expected to assume OPEB are discretionary and try to preserve the option to reduce them.

Other approaches to reducing the municipality's OPEB liability include charging or increasing premiums charged to employees and retirees, charging higher premiums to retirees than current employees (eliminating or reducing an implicit subsidy that GASB 45 requires being included in OPEB liability), increasing the length of time employees must work to be eligible, capping employer's total exposure, treating new employees less favorably than existing and prior employees, and/or shifting in whole or part to a defined contribution instead of defined benefit plan.

B. Continue pay-as-you-go.

In the short run this is the simplest and cheapest option. However, at some point in the future pay-as-you-go will become much more expensive than the ARC or fixed bond payments. Pay-as-you-go will result in an annually increasing NOO for GASB 45 purposes, and higher OPEB UAAL and ARC amounts due to an ability to apply a higher investment return assumption to the calculation of these amounts and may become a ratings factor (for example, Fitch Ratings has commented that "an absence of action taken to fund OPEB liabilities or otherwise manage them will be received as a negative rating factor").

C. Undertake a funding program, using either:

1. Special reserve or other dedicated fund within the treasury of the municipality. However, contributions to such an internal fund will generally not qualify as contributions toward the ARC nor as plan assets for GASB 45 purposes, which require an irrevocable contribution to a trust or equivalent arrangement protected from creditors and dedicated solely to providing benefits to retirees and beneficiaries in accordance with the terms of the OPEB plan. Therefore, an internal special reserve or similar fund will still be considered pay-as-you-go for GASB 45 purposes, and, in calculating the OPEB UAAL and related ARC, the investment return assumption applicable to deposits in such fund will likely be based on the municipality's return on its general (largely short-term) investments (roughly 2½ – 3% today) compared to the much higher investment return assumption (7% to 8%) used by pension funds, especially if large and diversified. The investment return assumption is the equivalent of a discount rate used in present valuing future OPEB payments, and the foregoing difference in investment return assumptions will make a very significant difference in

OPEB UAAL and ARC amounts (in some cases cutting them in half). Therefore, most municipalities choosing to undertake an OPEB funding program will use an OPEB trust of some kind. Some may use the special reserve fund option temporarily until a suitable OPEB trust is available.

2. *OPEB Trust.* Funding may consist of just the ARC or a larger portion of the UAAL, for which purpose the municipality may choose to use OPEB Bonds. See Chapter 11 for a discussion of OPEB trusts and Chapter 12 for a discussion of OPEB bonds.

3. *Insurance.* Note that most of the same objectives could be achieved by purchasing insurance for future OPEB obligations, but such long-term insurance is not currently available and cost and availability are likely to continue to foreclose or severely limit this option.

CHAPTER ELEVEN

OPEB TRUSTS

GASB 45 does not require OPEB liabilities to be funded or, if funded, by funding an irrevocable trust of some kind. However, as explained in of Chapter 10C, the existence of GASB 45 creates strong incentives to establish such a trust.

A. *Types of OPEB Trusts.*

The following types of OPEB trusts are each named for the section of the Internal Revenue Code from which they derive their exemption from federal income ta

1. 401(h) account. This is a separate account in a tax-qualified pension fund health benefits of retirees, their spouses and dependents. The aggregate actual contributions to this account cannot exceed 25% of the total actual contributions to the pension fund (other than contributions to fund past service credits) after the date on which the account is established. This limitation could present a problem for some municipalities' OPEB funding strategies, unless either the 401(h) account has been a component of the pension fund for a substantial period or the municipality is going to fund the pension benefits component of the fund at three or more times the amount at which it is going to fund the 401(h) account component. Amounts in a 401(h) account may not be used for or diverted to any other purpose, including pension income benefits.

2. 115 trust. This type of trust is considered exempt from federal income tax either because it is an "integral part" of a single governmental entity or because it serves an "essential governmental function" of one or more governmental entities. This is the type of trust most municipalities are likely to use, whether alone or in combination

with other municipalities – at least until adoption of 401(b) accounts by a majority of pension funds and quite possibly notwithstanding such a development.

3. 501(c)(9) trust. Also known as a "voluntary employees' beneficiary association" ("VEBA") trust, this is the primary vehicle used by the private sector for funding health benefits. Among the requirements are that membership be voluntary (which is deemed satisfied if mandated by collective bargaining agreement or if membership imposes no detriment and is required of all employees), and that the trust be controlled by its membership (which can be satisfied if the membership, directly or through representatives, designates the trustee or trustees who control(s) the trust, or if the trustee(s) are designated pursuant to a collective bargaining agreement). Because the form and operation of VEBA trusts are so well developed in the private sector, some municipalities may elect to adopt this model (or borrow from it in establishing a 115 trust.)

B. Characteristics of OPEB Trusts.

To accomplish the goals for which OPEB trusts are created (see Chapter 10[illegible], they generally must satisfy at least the following three requirements:

1. Exemption from federal income tax. In addition to income on investment of trust assets being exempt from income tax (as described in A above), contributions to the trust must not be treated as income to the employee or retiree (in each case under federal and state income tax laws).

2. Qualified trust for GASB 45 purposes. For contributions and deposits to count for GASB 45 purposes, they must be irrevocable, protected from creditors of the municipal employer and dedicated solely to providing benefits to retirees as beneficiaries in accordance with the OPEB plan (see discussion in Chapter 10[illegible]).

3. Broad investment powers, including equities. In order to be entitled to use the higher investment return assumption (see discussion in Chapter 10[illegible] above) and perhaps actually to earn a higher rate of return, the trust must be able to invest in a broader range of investments than those to which municipal funds are generally restricted, including the ability to invest in equities. In the absence of specific legislation governing investment by OPEB trusts in most states (and perhaps even if

there is such legislation, if the investment restriction is contained in the state constitution), it will generally be necessary to conclude that the OPEB trust is a pension or retirement fund within the meaning of any applicable exception to the restrictions otherwise applicable to the investment of municipal funds or that the OPEB trust is sufficiently separate from the municipality to not be included among the types of entities covered by state statutory (or, in some cases, constitutional) investment restrictions.

4. Single or multiple employer trusts. An OPEB trust may be a single employer trust established by and for a single municipality or a multiple employer trust established by an association or other collection of municipalities for membership by any interested municipality or by specific categories (such as, cities, counties, school districts, etc.)

CHAPTER TWELVE

OPEB BONDS

A. Advantages/Disadvantages.

The benefits of OPEB bonds are essentially the same as for pension obligation bonds (POBs) and are listed in Chapter 3 above, including interest rate savings (comparing bond interest costs against the investment return assumption/discount rate used in calculating the UAAL and ARC), arbitrage (see below), budget relief (compared to the ARC alternative), labor relations, and better than alternative strategies. Additional benefits pertaining to or receiving more emphasis as applied to OPEB bonds include the following:

1. Reducing the OPEB UAAL and ARC by funding a qualified trust entitled to use a higher investment return assumption (discount rate on future OPEB payments) than pay-as-you-go or funded internal reserve fund plans. This, in turn, also reduces the political burden of reporting a higher UAAL and the political and financial burden of budgeting for a higher ARC.

2. Lowering long-term cost of OPEB. While debt service on OPEB bonds (like the ARC) will generally be higher than pay-as-you-go costs for the first few years, pay-as-you-go costs (and resulting ARC costs and NOO) are likely to increase sharply, and after a few years exceed the cost of debt service and continue to grow thereafter.

3. Potential arbitrage opportunity, if not only the investment return assumption but also the actual investment return earned by the OPEB trust exceeds the yield on the bonds. As noted in Chapter 3, a 2004 study found 84% of POBs were in a positive arbitrage position and another 7% were at breakeven, notwithstanding substantial decline in stock market values in 2000-2002.

4. Reducing public pressure to reduce or discontinue OPEB benefits, which may result from publication of this substantial "new" unfunded liability, particularly in context of the growing debate over pension reform occurring in some states.

5. Credit rating protection. As noted above, rating agencies will be evaluating a municipality's strategy for managing its OPEB liability. A couple of rating agencies have indicated that OPEB bonds, properly used, will be considered a positive favor in a municipality's general credit evaluation.

The possible disadvantages of OPEB Bonds are the same as for POBs in Chapter 4 above, including replacing negotiable or even discretionary OPEB obligations with immutable bond obligations, the concentration of investment risk through lump sum deposit compared to spreading market timing risks by making ARC deposits annually, and possible negative arbitrage.

B. Types and Legal Authority.

Legal authority for OPEB bonds will vary from state to state and, within states, by type of entity. For some entities, the legal authority and structure will be essentially the same as for POBs:

1. General obligation bonds
2. Obligations imposed by law (OPEB variation, see discussion below)
3. Annual appropriation bonds
4. Asset-strip lease bonds
5. Revenue bonds (enterprise special districts and authorities)

See more complete discussion in Chapter 5A above. However, for the reasons discussed in Chapter 10A above, the "obligations imposed by law" theory used in California and some other states to support POBs may not be so easily applied to OPEB and, even if it could be applied, municipalities may not want to lose the option of treating OPEB as discretionary or negotiable by declaring them to count to be "obligations imposed by law." For those situations, we have developed a slightly different legal theory, which avoids that trap, but which for all other purposes would

function (and be structured) exactly like "obligations imposed by law" bonds. See discussion in Appendix B.

C. Taxable.

Just like POBs, interest on OPEB bonds will be included in gross income for federal income tax purposes, although they will usually be exempt from income taxes of the state in which the issuer is located. See more complete discussion at Chapter 6 above.

D. Federal Reimbursement Issuers.

Certain costs (including OPEB) of state and local governments in administrating programs under grants from or contracts with the federal government are eligible for reimbursement from the federal government pursuant to Office of Management and Budget Circular A-87. See discussion of effects of replacing direct costs with bond debt service at Chapter 7 above.

APPENDIX A

New York

A greater number of POBs (roughly 95) have been issued by the state and local governments in New York over the past decade than from any other state.

The issuance of POBs by local governments in New York was first authorized in 1989. The State and Local Employees Retirement System of the State of New York ("ERS"), the New York State Police and Fire Retirement System ("PFRS") and the New York State Teachers Retirement System ("TRS"; in the aggregate referred to as the "NYS Retirement System") were all modified in 1989 with respect to the method by which the annual contribution amounts were to be calculated in the future. As a result, each system was significantly underfunded, requiring a "catch-up" payment to return to actuarial full funding. Participating local governmental units were offered the option of (1) amortizing the UAAL amount due by a date certain through a direct loan from the State which carried an 8% (for TRS) or 8¼% (for ERS and PFRS) rate of interest until the liability was fully met, or (2) financing the UAAL through the issuance of general obligation bonds over the statutory period (applicable to the particular retirement system), or (3) paying cash by the date certain. Few local governments, except small jurisdictions with few employees, took the third option.

During the period 1989 through 1993, counties, cities and larger school districts in particular, issued general obligation bonds to pay off their then current balance of unamortized UAAL whenever interest rates dipped sufficiently to permit a lower net interest cost on their own bonds than the 8% or 8¼% rate being charged by the State. During this period, local governments could issue ten year general obligation bonds with net interest costs in the range of 6% to 7.75% depending on their credit rating. The 1989 legislation further provided that at such time as the

remaining amortization period was less than five years, local governments could no longer issue pension obligation bonds their own debt to pay off the outstanding balances. Thus, with a permitted maximum statutory amortization period of seventeen years for most UAALs, the possibility of financing of the 1989 UAALs ended in the 2001-2002 fiscal year of most local governments.

Beginning in 1995, the State adopted legislation almost every year creating new retirement incentive programs for various categories of State and local government employees, largely to support a goal of efficient downsizing of government. Generally, the legislation establishing these programs did not at the time include provisions for financing of the resulting unfunded liabilities. Such costs, which added to any existing UAAL, were paid either by amortization through the NYS Retirement System or by cash.

Concurrently in this time period, another type of pension-related program was developed by the State legislature which authorized local governments to create service award and defined benefit programs for volunteer ambulance and fire-fighting personnel. The legislation permitted the financing of contributions to certain of such programs attributable to years of volunteer service rendered during the five years prior to adoption of such programs. Such financing cannot be amortized over a period exceeding five years.

In 2003, new legislation was adopted for the purpose of structural reform in the method and manner of employer contributions to the NYS Retirement System, which legislation also included two provisions for the issuance of POBs:

1. Local governments are now permitted to issue POBs for any outstanding obligations to the State for any existing retirement incentive program (i.e., the retirement incentive programs established annually in the years from 1995 through 2002). (This provision was drafted by Orrick attorneys on behalf of the New York State Association of Counties.) The amortization period is limited to five years.

2. Similar to the 1989 legislation, a local government (and the State itself with regard to its own employees) is permitted to amortize a portion of its normal annual contribution for one fiscal year — that is, local governments are permitted

to amortize the amount due on December 15, 2004 to the ERS or PFRS component of the NYS Retirement System (except deficiency payments, adjustments relating to prior year payments, obligations for retirement incentives or other similar amounts) to the extent that such amount exceeds 7% of the estimated "pensionable salary" base for the then current fiscal year (2004–2005). This "amount eligible for amortization" may be amortized over a five year period at 8% with the State, or local governments are authorized to issue their own debt obligations to pay such amount, with maximum maturity not to exceed five years. On or about October 15, 2003, the State Comptroller is to determine the "amounts eligible for amortization."

The only type of financing specifically authorized for POBs in New York State are general obligation bonds (which obligations include a pledge of the full faith and credit and taxing power of the local government). These bonds must be issued in the same manner, under the same procedural requirements and subject to the same debt limits and other constraints as for any capital project of the local government. Mandatory or permissive referendum requirements applicable to general obligation bonds of the particular type of local government apply to bond resolutions authorizing POBs. For example, school districts must receive voter approval before issuing debt for any purpose authorized by the 2003 legislation. (Note that the legislation in 1989 exempted such school district POBs from the voter approval requirement; this omission in the 2003 legislation may be corrected during a future legislative session.) Likewise, fire districts would need prior voter approval. The bond resolutions of counties, towns and villages which authorize payment for five years or less are not subject to mandatory or permissive referendum. Similarly, city bond ordinances should not be subject to mandatory or permissive referendum unless specified by applicable special city charter provisions.

Once a bond resolution has been adopted by a local government authorizing the issuance of POBs, it is generally necessary to publish a legal notice of estoppel including a summary of the bond resolution and allow the 20-day estoppel period to elapse prior to the sale of the POBs. The purpose of the estoppel notice is to ensure that debt issued by the local government cannot be challenged on an

basis, procedural or otherwise, except on constitutional grounds once the estoppel period elapsed.

The New York State Legislature has also authorized the State itself to borrow in order to fund its UAAL on at least two occasions. In 1996, the State through the Dormitory Authority of the State of New York issued $773,475,000 of POBs as annual appropriation debt . These bonds had a final maturity in 2003. The 2003 legislation described above also amended the State Retirement and Social Security Law to authorize the State to amortize a portion of the State's contribution bill for the fiscal year ending March 31, 2005. The amortizable portion is calculated in the same manner as that permitted local governments. Likewise, the State may either amortize that portion through the office of the State Comptroller for five years at 8% or issue POBs.

In New York State, most municipal issuers also provide post-employment healthcare benefits to their retirees. Indeed, school districts, by law, have been prohibited since 1994 from reducing retiree healthcare benefits to less than those offered to current employees. This protection from unilateral reduction of benefits has been extended annually and continues through May 15, 2006 pursuant to Chapter 16 of the Laws of 2005. While numerous attempts to mandate such protection have been made in the State Legislature for cities, towns, villages, fire districts and other units of local government, none has succeeded to date. Nevertheless, many such local governments do in fact contractually provide such protection.

Historically, the New York State Retirement System has not been involved in the administration of OPEB and legislation would likely be necessary to expand its responsibilities from pensions to OPEB. Currently, each local unit of government contracts individually to provide OPEB benefits as an annual budgeted expense. Several of the municipal trade associations for specific levels of government are presently looking at formation of multi-employer trusts for their members.

Advance funding of OPEB liabilities through debt issuance by municipalities and school districts in New York State would require special state legislation declaring OPEB liabilities to be a valid public purpose (and providing some method of their calculation) in order to permit general obligation bonds to be issued. Like POBs,

OPEB bonds would be subject to the same constitutional and statutory requirements applicable to any capital project financing of the local government. In addition, such legislation could give the Common Retirement Fund on behalf of State or State and local employees and those local governments which may not have the express or implied powers to do so, the authority to set up and/or participate in OPEB trusts as described earlier.

APPENDIX B

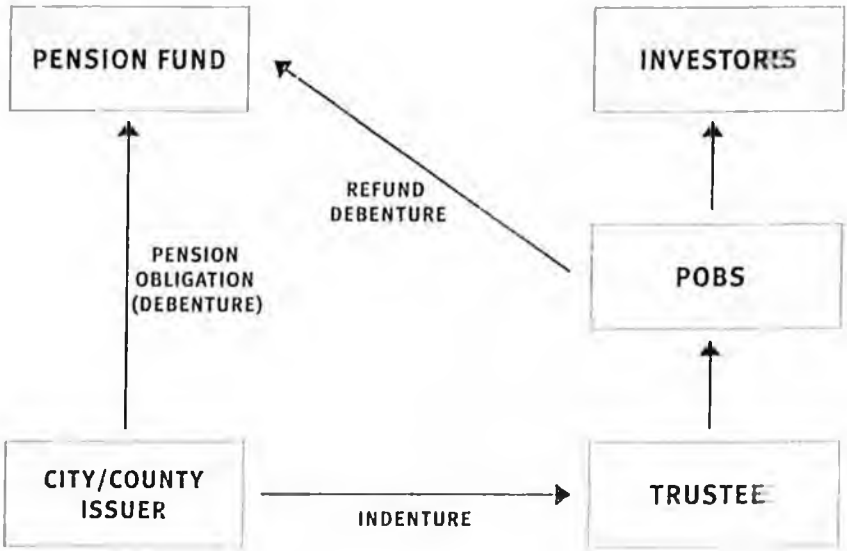
California

Pension obligation bonds had their start with the famous City of Oakland, California pension bond financing in 1985, the first POB in the country, which Orrick helped to invent and for which it served as bond counsel. That financing, and a number of copy-cats that rapidly followed were tax-exempt and primarily driven by then legal arbitrage possibilities. As explained in Chapter 6, tax-exempt POBs largely came to an end with the introduction of tax legislation that became part of the Tax Reform Act of 1986.

A new taxable version of POBs surfaced in late 1993. During the last decade since, seventeen or so cities and twenty-one or so counties in California have issued 90 POBs (second only to New York) aggregating $11 billion (more than from any other state). The California Statewide Communities Development Authority has established a pool POB program to lower costs and interest rates through economies of scale by pooling POBs issued by cities, counties and special districts.

California public entities do not have specific authority to issue POBs.[6] With the exception of one tax-exempt transition rule (see Chapter 6C) POB transaction issued as lease revenue bonds, all of these POBs have been issued under the local agency refunding law (drafted by Orrick a few years before for other purposes). However, the local agency refunding law authorizes all local public entities in California to refund prior bonds or "other evidence of indebtedness." The pension obligation to the county pension system, the California Public Employees Retirement System or other retirement system is memorialized as a "debenture," thereby becoming an "evidence of indebtedness," which can be refunded by POBs under the local agency refunding law.

6 The State of California enacted specific authority for State POBs in 2003 and again in 2004.



The POBs are typically structured as obligations payable from the general fund of the issuer. They are not full faith and credit taxing power general obligation bonds backed by the issuer's taxing power, because the California Constitution's debt limitation requires such type of bonds issued by the state, cities, counties or school districts ("Debt Limit Entities") to be approved by two-thirds of the electorate. Instead, California POBs issued by Debt Limit Entities have generally been designed to be valid without voter approval under a judicially created exception to the State Constitutional debt limitation, which exception is generally referred to as "obligations imposed by law." See discussion in Section A2 of Chapter 5. Because this exception to the Constitutional debt limit was and is much less developed in the case law (few cases not directly on point) than the other two judicially created exceptions (for lease financing and revenue bonds) each POB issue by Debt Limit Entities in California has been validated pursuant to California's validation statute (Code of Civil Procedure §§860 *et seq.*). Entities other than Debt Limit Entities, meaning authorities, agencies and districts of various kinds (other than school districts and community college districts), because they are not subject to the Constitutional Debt Limit, need not rely on "obligations imposed by law theory" and can simply use the local agency refunding Law as authority for this issuance of POBs, without a validation action.

While there have been many validation actions for POBs, they have no precedential value or application to any transaction other than the specific transaction(s) validated.

What is validated in such validation actions is not legal principles but the bonds and the other principal legal documents approved in a bond resolution. Before the validation action is filed, it is necessary for the state or local government issuer to first adopt the resolution and authorize the bonds, the documents and the validation action. The validation action is filed in the superior court of the county in which the issuer is located, and an order for publication of summons is received. Summons can then be published (usually in a newspaper of general circulation in the city or county in which the issuer is located), which takes a minimum of 21 days. If no one answers the complaint by the date specified in the summons, which must be at least 10 days after completion of publication, the clerk can enter a default, and schedule a hearing before the judge for the default judgment (the timing of which will depend on the jurisdiction, and may be a day or two or, in some jurisdictions, at least 15 days after the clerk enters the default).

So assuming the very best case, obtaining a validation judgment takes a minimum of 31 to 40 days (depending on the jurisdiction) after filing the validation complaint. Of course, issuers are at the mercy of the judge and the clerk, and it sometimes takes a week or more to get an order for publication of summons, or longer than 15 days after the clerk enters a default to schedule the hearing. In addition, the judge could take the matter under submission for an indefinite amount of time, or even disagree with the proposed default judgment, and decline to validate the transaction. Once granted, the default judgment may be appealed within 30 days, but only on jurisdictional grounds. Therefore, it is typically assumed that the validation action will take approximately 60 days (not including the appeal period). It is generally considered reasonable to sell the POBs without waiting for the 30 day appeal period to run, assuming no one has answered the complaint, because the grounds for appeal are so narrow, but usually the bond closing does not occur until after the appeal period has expired.

If someone does answer the complaint, then there is true two party litigation on the merits. While some expedited procedures are available, the timing for resolution of the litigation cannot be predicted, and may take many months unless settled or abandoned. So far, no one has answered the complaint and default judgments have been obtained for every city and county POB issuer. However, the same was not true of the State of California, whose validation complaint was answered by the Howard Jarvis Taxpayers Association, and resulted in a decision on September 23, 2003 by the Superior Court in Sacramento County declining to validate the State's proposed POBs. Similarly, a second validation brought by the State was answered by the Fullerton Association of Concerned Taxpayers and resulted in a decision on October 25, 2005 by a different judge of the Superior Court in Sacramento County to the effect that the State has imposed its pension obligations on itself, distinguishing those imposed on local government by the State, and therefore the State's pension obligations are not obligations imposed by law. The State, as of this writing, is appealing this decision.

The validation actions can and usually do validate not only the POBs to be issued but also any future POBs or refunding POBs. Not all validation actions are as inclusive or as flexible as they could be (some leaving out future new money or refunding POBs or costs of issuance or locking in semiannual interest payment dates, etc.), and must be carefully reviewed before relied on for future POBs or refunding POBs.

Note, as mentioned in Section A2 of Chapter 5, that the "obligations imposed by law" concept that is generally used to support POBs in California does not support reserves or capitalized interest because inclusion of such components in the bond issue are considered volitional not mandatory (as evidenced by the numerous California POBs issued without them) and therefore not "obligations imposed by law." Costs of issuance, on the other hand, can be included on the theory that they cannot be avoided. The inability to include capitalized interest makes achieving current budget relief more challenging (see discussion of structure options in Section C of Chapter 5). Alternatively, the POBs could be issued as annual appropriation bonds or asset-strip lease revenue bonds (see Section A3 and 4 of Chapter 5) which can include reserves and capitalized interest.

OPEB come in a variety of different forms: collective bargaining agreements, employment contracts, MOUs, ordinances, board policies, even historical practices not supported by formal action – many of which are short-term, subject to reauthorization, renegotiation or discretion. Therefore, the case for "obligations imposed by law" treatment may not work as well in each case for OPEB as it has for pension obligations. Even if "obligations imposed by law" theory could apply, based on the particular facts or legislation or validation action, most municipalities do not want to take a definitive legal position that its OPEB obligations are legally binding obligations imposed by law.

Therefore, the Orrick team has developed a separate legal theory which avoids these problems but otherwise functions exactly like "obligations imposed by law" so far as the financing structure described above for POBs is concerned. That is why we refer to it as a "first cousin" to obligations imposed by law. The main difference is some of the arguments made in the validation papers.

Even entities that are not Debt Limit Entities, and therefore do not need to rely on an "obligations imposed by law" theory or any variation and do not need a validation action, will encounter some of the same issues because, in relying on the local agency refunding law, they still must have some "evidence of indebtedness" to refund. However, a variation on the POB structure can address this problem as well.

Most OPEB bonds in California are likely to follow very closely the form and structure of POBs. The same alternative structures (annual appropriation bonds or asset-strip lease revenue bonds) would also be available.

APPENDIX C

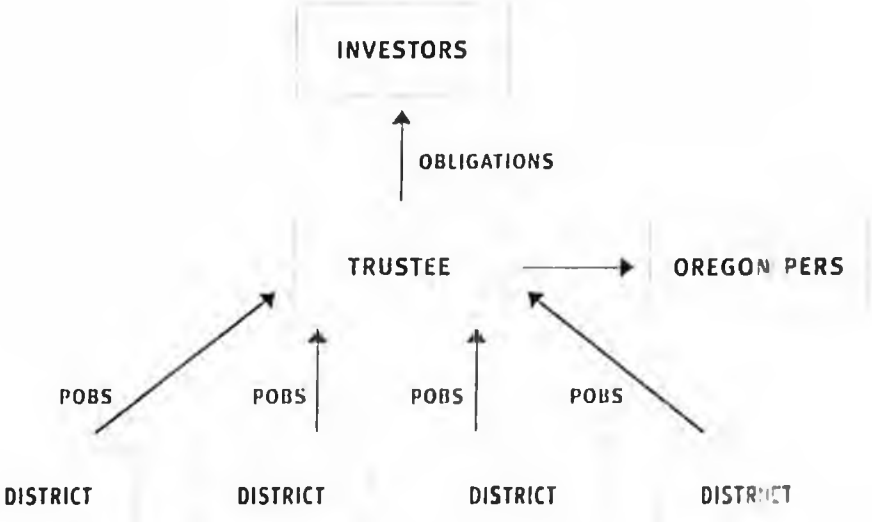
Oregon

State and local government issuers in Oregon have been among the most active users of POBs to finance their share of unfunded liability to the Oregon Public Employees Retirement System. POBs are issued in Oregon either as limited tax bonds or as revenue bonds.

Prior to the passage of the Pension Bonding Act in 2001, the City of Portland, Multnomah County and Josephine County issued significant sized POBs under Oregon's Uniform Revenue Bond Act. In 2001, the Oregon Legislative Assembly approved the Pension Bonding Act (which Orrick attorneys were involved in drafting). The Pension Bonding Act granted authority to "governmental units," including cities, counties, school districts, special districts, public corporations and intergovernmental corporations, to sell full faith and credit obligations for the purpose of refinancing pension obligations. POBs issued under the Pension Bonding Act are not subject to voter approval or annual appropriation and may be issued by local governments individually or jointly.

Significant pooled POB issues have been done by Oregon school districts, community college districts and local governments pursuant to the Pension Bonding Act. In these transactions, the participants pledged their full faith and credit within the limitations of the Oregon Constitution and issued limited tax bonds, payable from available general funds of the issuer. Available general funds include all ad valorem property tax revenues received from levies under each issuer's permanent rate limit and all other unrestricted taxes, fees, charges and revenues legally available to pay debt service on the POBs. The issuers are not authorized to levy additional taxes to pay the POBs.

In the pooled school district and community college district transactions, individual districts issued limited tax POBs in favor of a bond Trustee, which in turn issued obligations that represent a proportionate and undivided interest in and right to receive POB payments pursuant to a Trust Agreement. These POBs have been further secured by an Intercept Agreement between the State Department of Education and the school districts and community colleges under which the Trustee was authorized to intercept specific education revenues otherwise paid by the State to the school districts and community colleges in an amount equal to the debt service on each issuer's POBs. Since 2003, several pooled POB issues have been completed for Oregon school districts, education services districts, community colleges, counties, cities and special districts. Each of the pooled transactions to date have been enhanced by bond insurance. By pooling these transactions, the issuers were able to increase the amount of bonds sold, which increased access to investors, lowered interest rates and reduced costs of issuance.



Other jurisdictions, including the City of Portland, City of Corvallis, Multnomah County, Marion County, Josephine County, Eugene Water and Electric Board and Portland Community College District have sold POBs on a stand-alone basis.

As an alternative to issuing POBs as limited tax bonds pursuant to the Pension Bonding Act as described above, issuers have the option to issue POBs as revenue bonds pursuant to the Uniform Revenue Bond Act or the Pension Bonding Act. The Uniform Revenue Bond Act allows municipalities to issue revenue bonds for any public purpose secured by designated "revenues," which may include taxes and virtually all other general and special fund revenues and receipts of the municipalities. The financing authority provided by the Uniform Revenue Bond Act is broad enough to include legal authority for pubic bodies in Oregon to issue POBs. The Uniform Revenue Bond Act requires issuer approval pursuant to a nonemergency ordinance or, in the alternative, a resolution followed by notice and a 60-day referendum period, during such period the revenue bonds may be referred to a vote of the electorate if a referendum petition is signed by at least 5% of the issuer's electors in the case of a resolution or, in case of a nonemergency ordinance, as specified in the applicable charter or code provision. Revenue bonds issued pursuant to the Pension Bonding Act are exempt from this potential referendum requirement.

With respect to potential OPEB bond issues in Oregon, the financing authority provided by the Uniform Revenue Bond Act and the Pension Bonding Act is believed to be sufficiently broad to permit public bodies in Oregon to issue OPEB bonds. However, because of the unique issues associated with OPEB bonds and particularly OPEB trusts, it is anticipated that special OPEB bond legislation will be sought in the 2007 Legislative Session.

In a special election the fall of 2003, Oregon voters approved an amendment to the Oregon Constitution authorizing the State Treasurer to issue POBs as general obligation bonds of the State of Oregon for the purpose of paying substantially all of the State's UAAL. The amendment provided that the general obligation of the State must contain a direct promise on behalf of the State to pay the principal, premium, if any, and interest on that indebtedness. The State is also required to pledge its full faith and credit and taxing power to pay that indebtedness; however, the ad valorem taxing power of the State may not be pledged to pay that indebtedness. The amount of POB indebtedness authorized by the amendment that may be outstanding at any time cannot exceed 1% of the real market value of all property in the State. In