11673 HOUSE STATE AFFAIRS

1. Executive Summary

Executive Summary

Why are we here?

Public employers in the State of Alaska are facing substantial funding shortfalls relative to thei obligations (on an actuarial basis).

Alaska Public Employers PERS/TRS Unfunded Liability as of June 30, 2004*	Present Value
Total PERS	**$3,413 million**
State of Alaska Share	2,023 million
Municipality of Anchorage Share**	462 million
Fairbanks North Star Borough Share***	70 million
City & Borough of Juneau Share	63 million
Remaining 185 Employers Combined	794 million
Total TRS	**$2,278 million**

* Based on Mercer Consulting Actuarial Report.

** Includes both Municipality of Anchorage and Anchorage School District Share

*** Includes both Fairbanks North Star Borough and Fairbanks North Star Borough School District Share

Executive Summary
What is a UAL?

What is a UAL? Actuarial computations compare the costs of future benefits to a projection of assets available to meet those costs. A shortfall is known as an Unamortized Actuarial Liability or UAL.

UAL = **PV of Assumed Future Benefit Costs**

Key Drivers:
- Benefit Levels
- Health Care Costs
- Employment / Retiree Patterns

less

PV of Assumed Worth of Past and Ongoing Contributions

Key Drivers:
- Contribution Levels
- Earnings Rates
  - Assumed
  - Actual

Executive Summary
Major Points of This Presentation

Section	Key Points
2 What is Pension Financing?	Pension financing is an increasingly common tool that allows municipal issuers to amortize unfunded pension liabilities at a lower interest rate than the rate assumed by actuaries
3 Potential Savings Analysis	The potential present value savings from pension financing are significant:* •System-Wide PERS: $876 million - $1.16 billion (approximately $100 million per year) •System-Wide TRS: $586 - $761 million (approximately $64 million per year)
4 Risk Analysis	Pension financing is not without risk. • The principal financial risk is that the PERS/TRS investment portfolio returns less than the interest rate on the bonds (5.80%) over the 20-30 year life of the bonds. Although history argues against such a dire investment projection, this result is possible • Political developments and/or retirement system changes fundamentally alter landscape
5 Implementation Considerations	The exact legal form of pension financing in Alaska is still unclear. HB278 would provide an approach for local governments to finance on their own or in "pools" via the Bond Bank. Certain issuers may also be able to finance on a stand-alone basis
6 Oregon Example	This technique has been widely employed across the US. In Oregon, the City of Portland issued pension bonds in 1999, other municipalities followed, and finally the State executed a pension financing for its own account in 2003

* Lower end of savings range based on 8.25% PV rate. Higher end of PV savings range based on 5.80% PV rate. Please see page 10 of this presentation for important disclosure of the calculation of the numbers on this page.

2. What is Pension Financing?

What is Pension Financing?

Overview

Description

- All public employers make annual contributions to future benefit costs
- These payments are based on an actuarial evaluation of future costs and go in an account at PERS/TRS
- When value of this account falls below the estimate of future obligations, the difference is known as the UAL
- State-Wide "UAL's":*
  - PERS: $3.4 billion
  - TRS: $2.2 billion

Economics

- The UAL is 'repaid' or amortized to PERS/TRS over 30 years, assuming assets will earn 8.25%
- Effectively, the PERS/TRS account is "lending" the employer the UAL at a loan rate of 8.25%
- With pension financing, the employer borrows, via bonds, money to fund the UAL today. It then repays investors at a rate lower than 8.25%
- In today's market, an employer could borrow at an all-in taxable rate (i.e. interest rate including all financing costs of issuance) of approximately 5.80%

Considerations

- Complexity of analysis and cash flows
- Risk that savings will be less than expected (i.e. investment risk - see section 4)
- Credit rating risk (see section 4)
- Unused technique in Alaska (see sections 4 & 5)
  - Local authority/legal structure
  - Political uncertainty

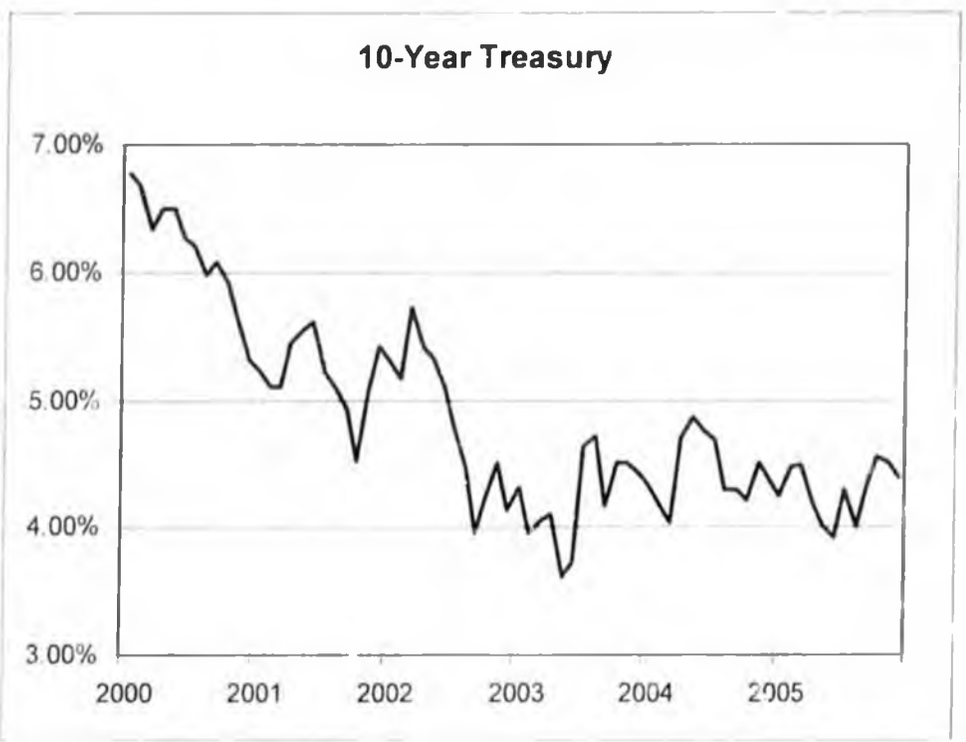
* As of June 2004 based on Mercer Actuarial Report

What is Pension Financing?

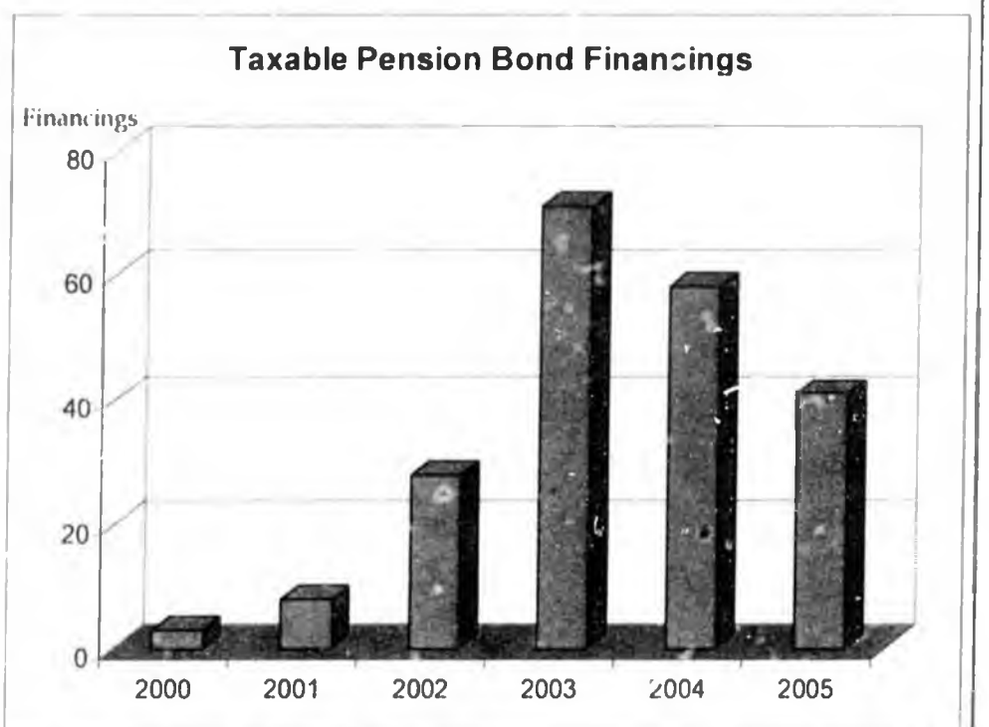
Growth in Pension Financing Solutions

Acceptance of pension financing solutions has grown considerably over the past four years.

As taxable fixed rates have dropped to historic lows...



...pension financing solutions have become common.



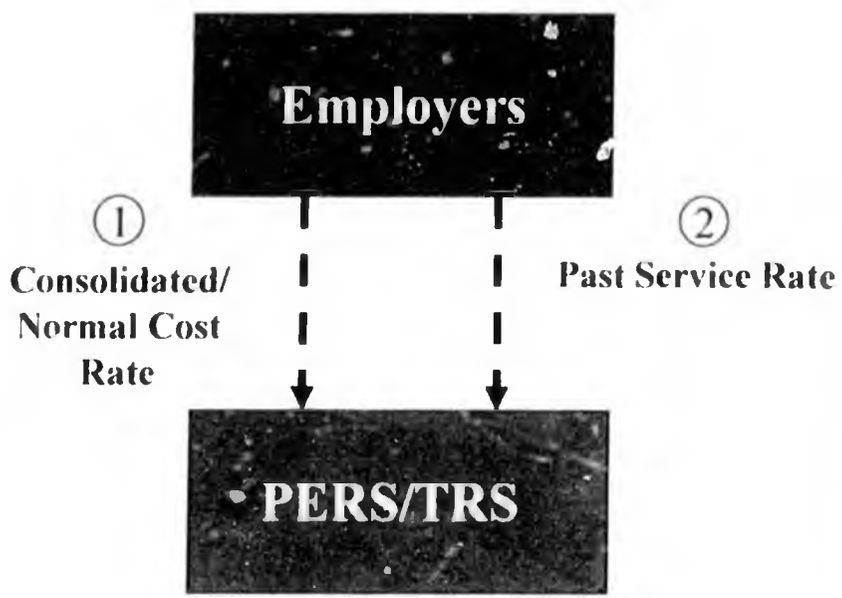
Many other municipalities and states – including Illinois, Wisconsin and Oregon – have implemented pension financings to help solve state-wide underfunding. The City of Portland issued pension bonds in 1999 (senior managed by current Merrill Lynch bankers), after which other municipalities and the State then followed.

3. Potential Savings Analysis

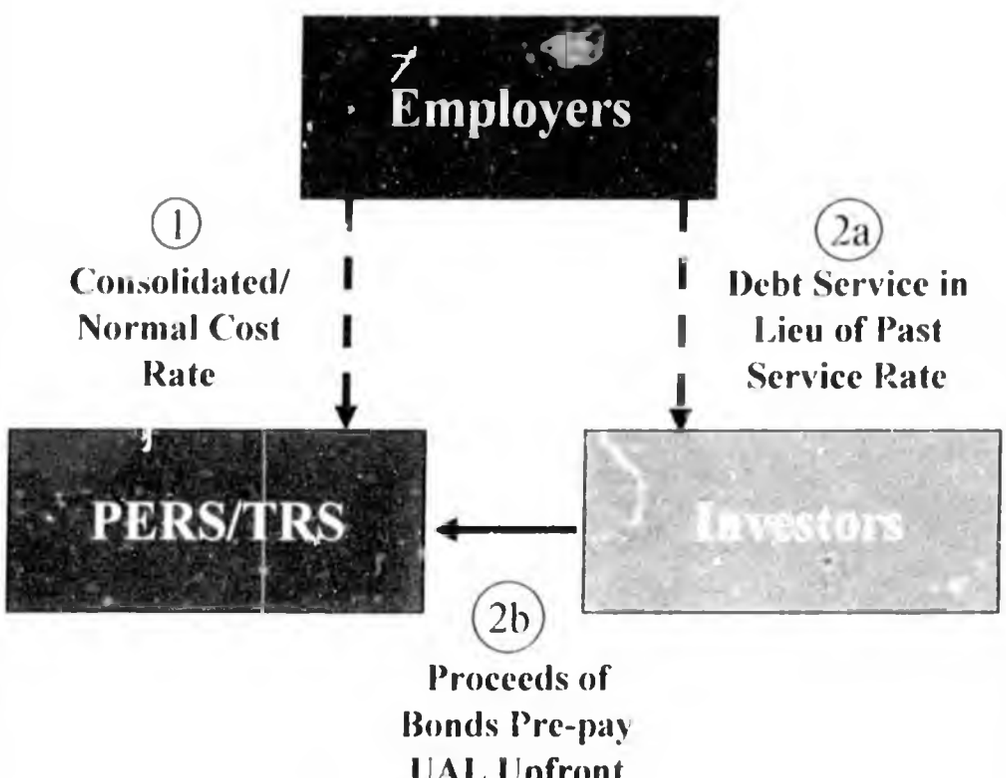
Potential Savings Analysis

UAL Past Service Rate Replaced by Lower-Cost Bond Debt Service

Status Quo



Pension Financing



(1) "Staying Current": Annual cost of future benefits for current and future employees.

(2) "Getting Caught Up": Amortization of past under-funding of future benefits not yet provided for.

Potential Savings Analysis

System-Wide PERS ($3.4 billion UAL)*

2009 Estimated Pension Costs

Status Quo		After Pension Financing	
Consolidated Rate (x):	$233,009,263	Consolidated Rate (x):	$233,009,263
Past Service Rate (y):	$276,932,181	Past Service Rate (y):	N/A
Debt Service on Pension Bonds (z):	N/A	Debt Service on Pension Bonds (z):	$200,192,512
Total Estimated Pension Costs (x+y):	$509,941,444	Total Estimated Pension Costs (x+z):	$433,201,775

2009 Difference: $76.7 million

Estimated Present Value Savings

Status Quo		After Pension Financing	
PV of Past Service Rate:	$3,413,502,000	PV of Debt Service on Pension Bonds:	$2,536,552,430

2006-2030 PV Difference: $876.9 million**

Note that the above numbers are system-wide numbers which assume the entire unfunded liability is financed. The impact for a specific employer would depend on that employer's particular unfunded liability.

** 8.25% PV rate

** Please see page 10 of this presentation for important disclosure on our calculation of the numbers on this page.*

Potential Savings Analysis

System-Wide TRS ($2.2 billion UAL)*

2009 Estimated Pension Costs

Status Quo		After Pension Financing	
Normal Cost Rate (x):	$84,254,490	Normal Cost Rate (x):	$84,254,490
Past Service Rate (y):	$185,900,114	Past Service Rate (y):	N/A
Debt Service on Pension Bonds (z):	N/A	Debt Service on Pension Bonds (z):	$138,290,466
Total Estimated Pension Costs (x+y):	$270,154,603	Total Estimated Pension Costs (x+z):	$222,544,956

2009 Difference: $47.6 million

Estimated Present Value Savings

Status Quo		After Pension Financing	
PV of Past Service Rate:	$2,278,230,000	PV of Debt Service on Pension Bonds:	$1,692,037,245

2006-2030 PV Difference: $586.1 million**

Note that the above numbers are system-wide numbers which assume the entire unfunded liability is financed. The impact for a specific employer would depend on that employer's particular unfunded liability.

** 8.25% PV rate

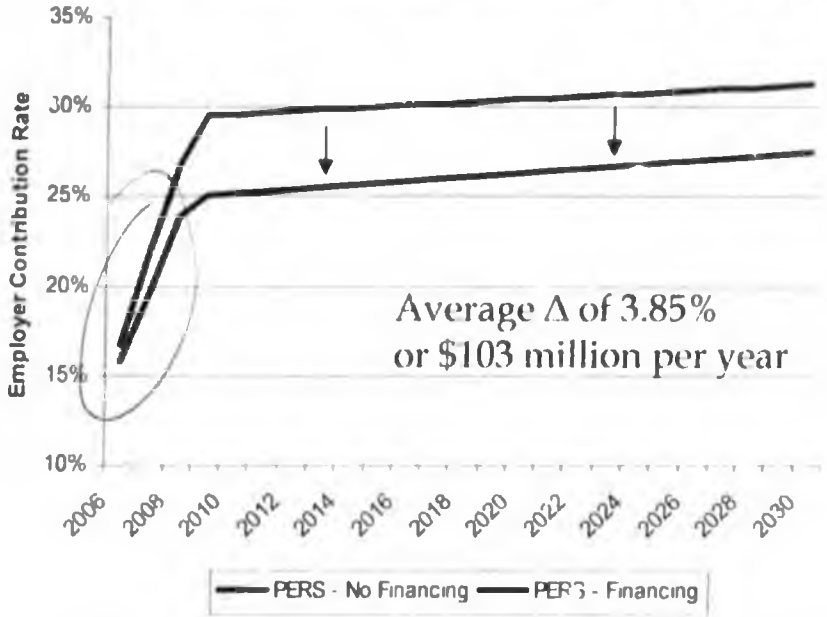
** Please see page 10 of this presentation for important disclosure on our calculation of the numbers on this page.*

Potential Savings Analysis

Potential Employer Contribution Rate Impact*

Pension financing could drop contribution rates for employers significantly and immediately.

System-Wide PERS

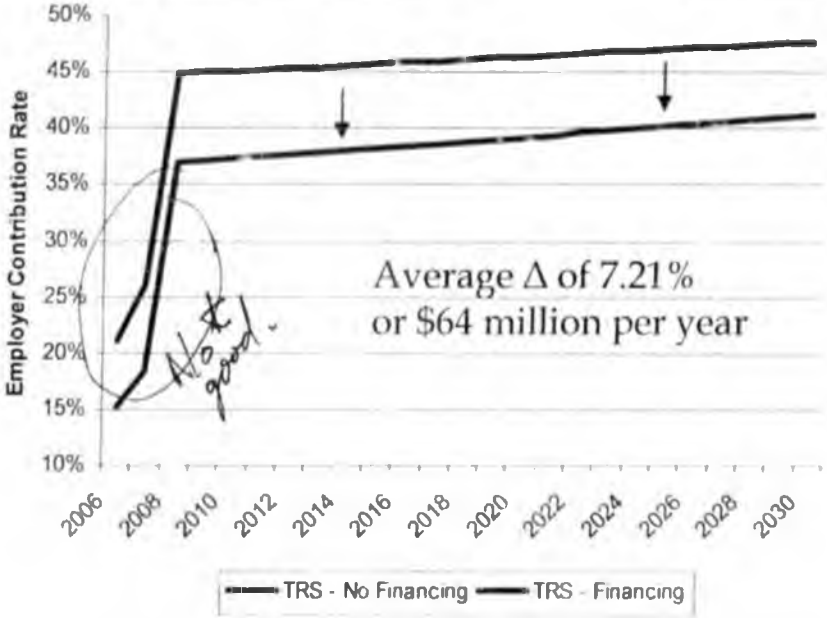


UAL: $3.41 billion

Potential Total Savings: $2.5 billion

Potential PV Savings: $876 million-1.16 billion(1)

System-Wide TRS



UAL: $2.27 billion

Potential Total Savings: $1.6 billion

Potential PV Savings: $586-761 million(1)

Note that the above numbers are system-wide numbers which assume the entire unfunded liability is financed. The impact for a specific employer would depend on that employer's particular unfunded liability.

(1) Lower end of savings range based on 8.25% PV rate. Higher end of PV savings range based on 5.80% PV rate.

* *Please see page 10 of this presentation for important disclosure on our calculation of the numbers on this page.*

Disclaimer

Please note that the numbers on pages 3, 7-9, and 26-29 of this presentation are Merrill Lynch's best estimate of future pension financing savings and employer contribution rates based on information in the PERS/TRS Actuarial Valuation Report as of June 30, 2004 (including supplemental report). It should be noted that future employer contribution rates will be calculated by the PERS/TRS actuary, not Merrill Lynch. In addition, future employer contribution rates will be influenced by unpredictable events such as investment portfolio returns, health care cost assumptions and experience, demographic changes, and other factors which impact the funding levels of the PERS/TRS system. For instance, if the PERS/TRS investment portfolio returns less on an average annual basis than the actuarial assumption of 8.25%, future employer contribution rates will likely be higher than the projected employer contribution rates provided in this presentation. In addition, if the proceeds from a pension bond financing earn less on an average annual basis than the interest rate on the pension bonds for the life of the bonds, the entity issuing the pension bonds could be worse off than had it not issued the bonds.

4. Risk Analysis

Risk Analysis

Key Variables Underlying UAL Calculation

Paying off the UAL is the fundamental objective. What key drivers could change the UAL?

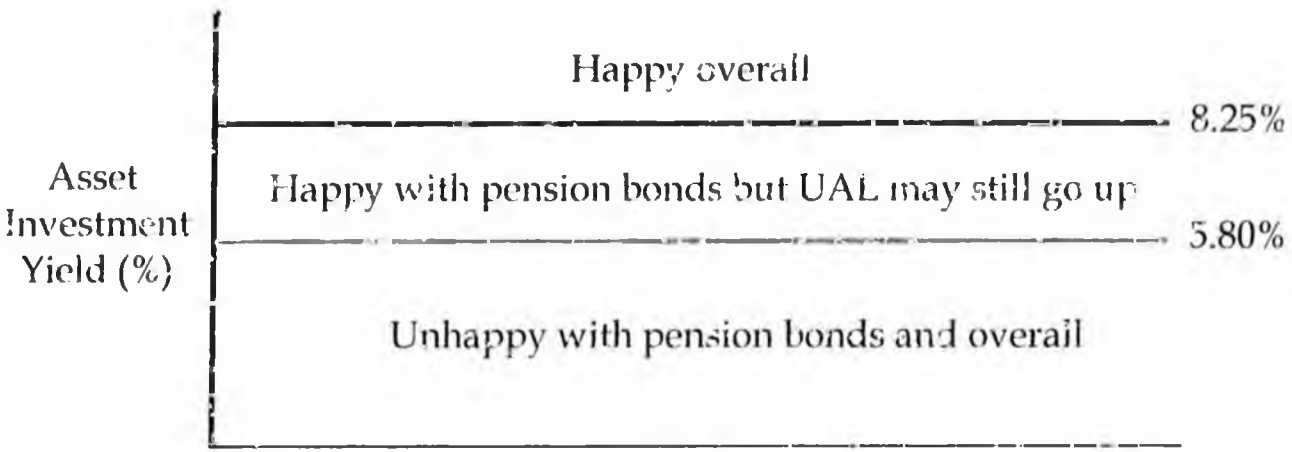
	Description	Considerations
Cost of Benefits Assumptions	How much will it cost to provide benefits in the future?	• Medical benefit cost growth has been a major factor
Assumed Earnings Rate	What investment rate does actuary assume will be earned?	• Current assumed rate for PERS/TRS is 8.25%
Actual Earnings Rate	What investment rate will asset actually earn?	• No certainty. Only assumptions based on historical returns. See historical averages on page 15

Risk Analysis

How do we evaluate financial success of a financing approach?

Is it important to identify incremental risk associated with the financing.

- The PERS System has net assets of $8.59 billion and the TRS System has net assets of $4.02 billion
  - All other things equal, when those assets earn < 8.25%, the UAL goes up
- In a bond scenario, you finance your contribution at 5.80% in today's market
  - As long as those bond-funded assets earn more than 5.80%, you are better off for having borrowed



Risk Analysis
Summary of Other Key Risks

	Description	Considerations
Investment Risk	Risk that proceeds contributed upfront could earn less than the bond rate	• Historic investment performance • Historically low borrowing rate • See next two slides
Credit Risk	Risk that additional debt could negatively impact bond credit ratings	• Rating agencies support well-structured pension finance programs (see page 16)
Financing Risk	Customary financial market risks; market timing; disclosure; staff time	• No different than any other financing undertaken for savings, with exception of higher financing costs due to new and more complex credit
Political Risk	Risk of an individual employer taking the lead ahead of a Statewide solution	• What if an employer borrows and State funds UAL later through bonds or cash contribution? • What if State provides credit support to pension bonds after an employer sells bonds?

Risk Analysis
Investment Risk

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

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)

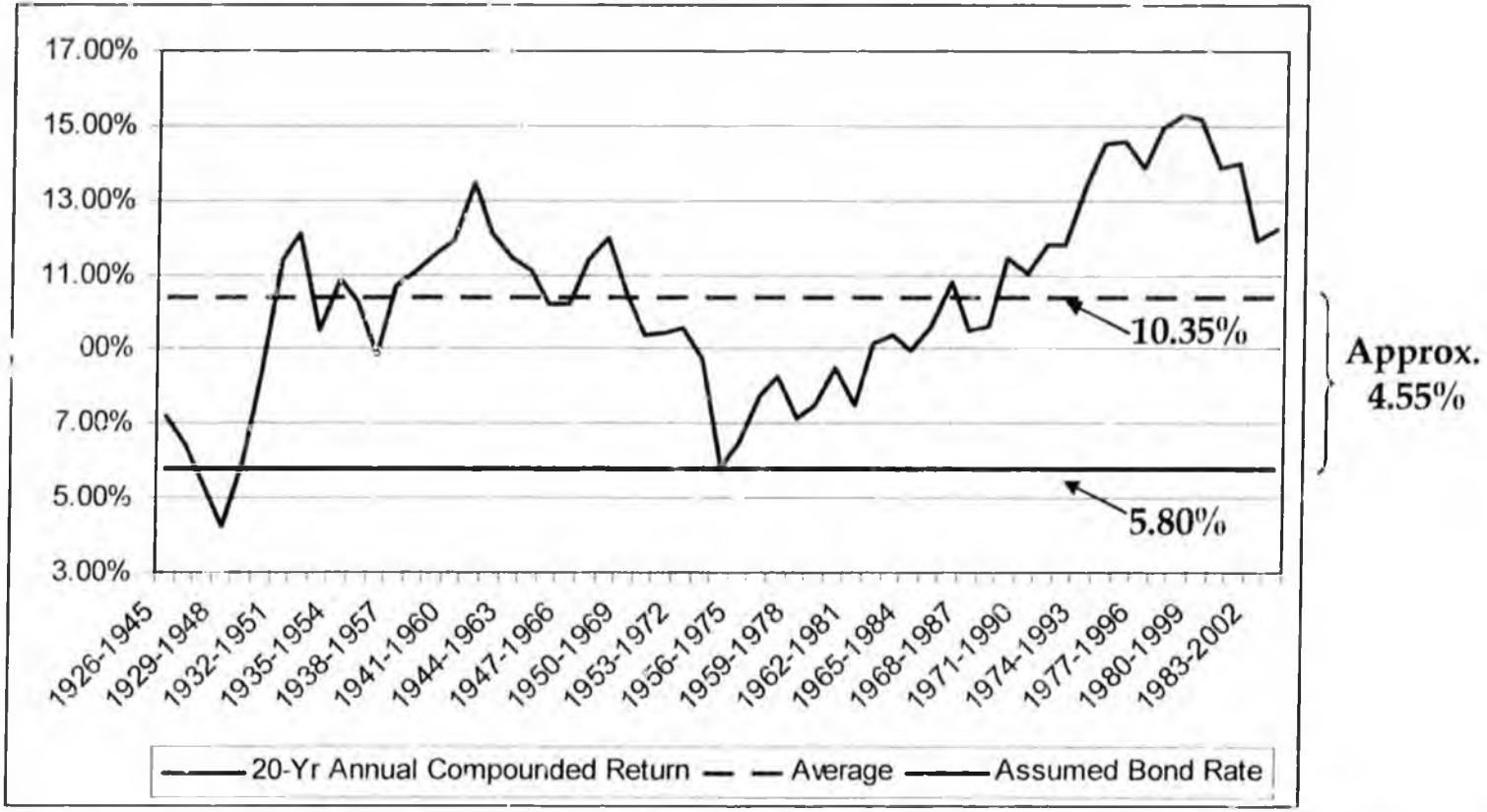
	PERS Change in Funded Status	TRS Change in Funded Status
Change Due to Assets	[illegible]	[illegible]
Change Due to Liabilities	**-18.5%**	**-26.6%**
Total Change in Funded Status	**-22.3%**	**-29.3%**

***Key Takeaway:* the poor stock market was NOT the driving force behind the underfunding of the retirement system.**

Risk Analysis
Investment Risk

As long as the bond proceeds that are invested in PERS/TRS yield more (over the 20-30 year life of the bonds) than the bond rate, you are better off financially for having borrowed.

Compounded Annual Return Over 20-Year Periods of Portfolio of 70% Stocks and 30% Bonds*



With the exception of the 20-year periods beginning in 1928 and 1929, a 70% stock / 30% bond portfolio since 1926 has always returned more than today's assumed pension bond rate.

* Compounded annual returns from Ibbotson Associates "2004 Yearbook". Portfolio comprised of 70% stocks (2/3 large cap and 1/3 small cap) and 30% long-term corporate bonds.

Risk Analysis

Credit Risk: Does pension financing damage credit ratings?

Rating Agency Perspectives

- **Common Tool:** Over 160 taxable pension financings in past 3 years, which are helpful case studies on credit impact.

- **Maintenance of Existing Ratings Common:** Pension bonds simply replace the "soft" future liability of high employer contributions with a "hard" future liability of bond debt payments. To maintain ratings, issuers must:
  - Structure pension bonds conservatively to achieve equal employer savings over time;
  - Use conservative actuarial assumptions in their savings calculations;
  - Incorporate pension bonds as one tool of a larger, comprehensive pension plan;
  - Example: City of Portland maintained AAA GO rating and Aa2 limited-tax rating after pension bonds.

- **Limited Potential for Adverse Credit Impact:** Illinois downgraded to credit "negative" by S&P and downgraded from Aa2 to Aa3 by Moody's. S&P cited numerous reasons for downgrade, including "a reliance on *one-time revenues, including $2 billion in pension obligation bonds*, to balance the 2003 and 2004 budgets." ***That said, downgrade would likely have happened even without pension bonds.***

5. Implementation Considerations

Implementation Considerations

Bond Funding Solutions

Question: How can local governments – school districts, municipalities or municipal enterprises – pre-pay their unfunded accrued actuarial liabilities (UAL) without incurring "debt"?

Traditional Approaches:

General Obligation Bonds: State Constitution requires funding a "capital improvement." Of note: many public entities outside of Alaska can use GO Bonds for pension financings.

Revenue Bonds: Require a separable, pledgeable revenue stream.

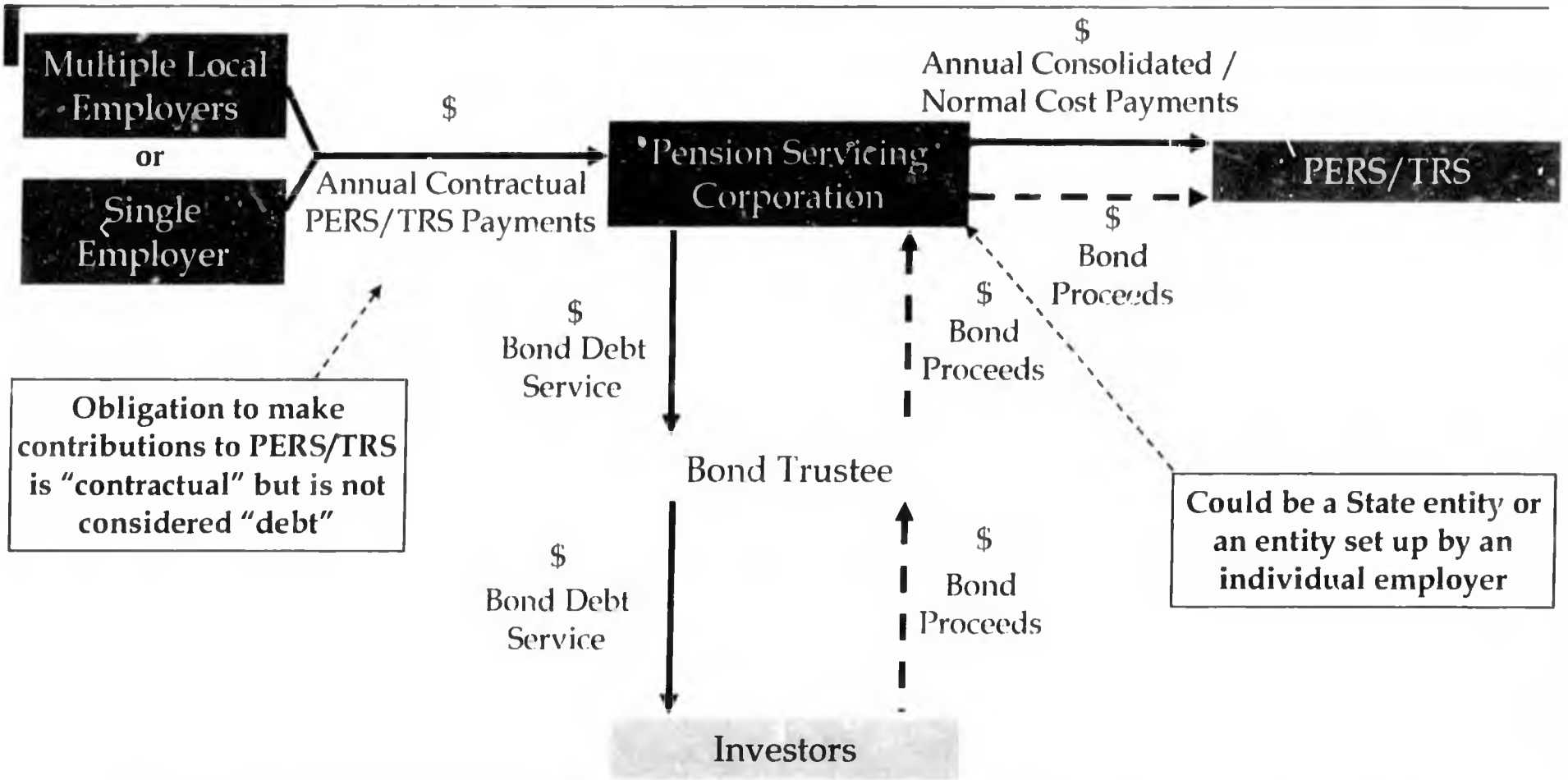
Potential Solutions:

Debt Issued Via Funding Conduit: ***Local contributions to PERS/TRS not considered debt.*** Municipalities agree to make annual PERS/TRS payments to funding conduit. Funding conduit sells pension bonds. Pension bond proceeds pre-fund accrued liabilities. Funding conduit divides those payments between those going to debt service on bonds and payments to PERS/TRS. Conduit could be State-wide or created by an individual employer.

Appropriation Bonds By Larger, Well-Rated Municipalities: It is debatable, but some lawyers do not consider appropriation-backed debt to be GO debt, since debt payments are not based on full faith and credit of municipality.

Implementation Considerations

Debt Issued Via Funding Conduit



Representative Hawker introduced House Bill No. 278 (included as Appendix B) last April which would make the Bond Bank the "Pension Servicing Corporation" (red box above) for multiple local entities. The bill will remain active in the upcoming session. Certain employers such as the Municipality of Anchorage would probably not need the Bond Bank if it chose to issue pension bonds on its own.

Implementation Considerations

Key Aspects of House Bill No. 278

- Entitles Bond Bank or Bond Bank Subsidiary to assist government employers by issuing bonds to enable employers to pre-pay unfunded liabilities of retirement systems.
- Authorizes government employers to contract with—and to issue bonds, notes, or commercial paper to—the Bond Bank or Bond Bank Subsidiary for that purpose.
- Specifies no expectation of subsidization with State funds.
- Consolidated bond-based approach provides municipalities with unified solution.
- Bonds issued by the Bond Bank are additionally secured by a Moral Obligation of the State. That said, none of our discussions with the State have contemplated a State moral obligation to back local pension bonds.

Implementation Considerations

Next Steps

- Respond to feedback from legislators and government officials, further refine analysis
- Develop detailed legal approach
- Discuss HB278 with legislators
- Discuss with Department of Revenue

6. Oregon Example

Oregon Example

Case Study: Pension Obligation Finance in Oregon

Over $6.2 billion of pension obligation bonds have been issued in Oregon since 1999

- A wide range of public employers have issued pension bonds:
  - The State
  - The City of Portland
  - Multnomah County (the County that Portland sits in)
  - School Districts
  - Port of Portland
- In Oregon, UAL's were driven by:
  - Changes in taxability of benefits
  - Mismatched investment options: employee vs. employer contributions
  - Increased cost of benefits
- A variety of alternatives have been used including stand alone and pooled financings and fixed and variable debt

Oregon Example

The City of Portland's Approach

The City issued $350 million of pension bonds in 1999

- At the time, the City's UAL had roughly doubled to $260 million over a two year period
- Portland's contribution rate was slated to increase by roughly 7%
- Given the strong stock market at the time and then-current low borrowing rates, the City chose to issue POBs
- At the time, the stock market had enjoyed a strong run and borrowing rates were attractive

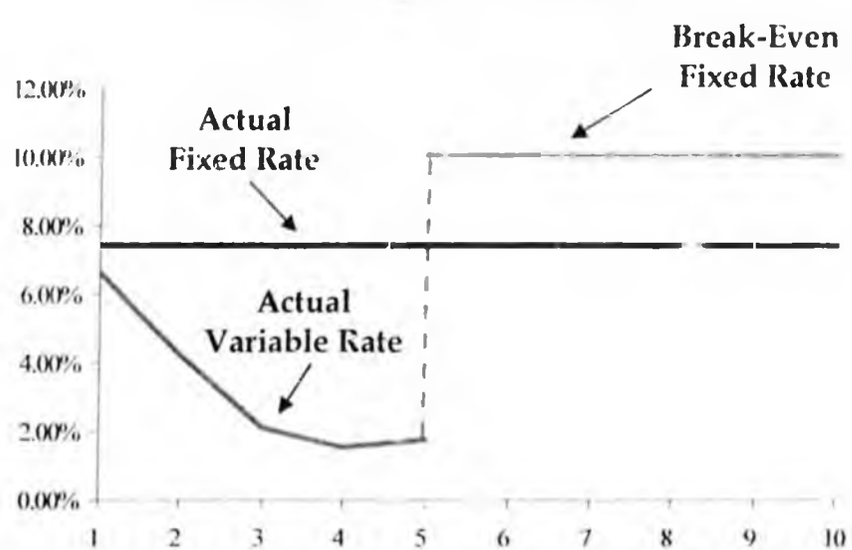
Oregon Example

The City of Portland's Results

The City funded 100% of their UAL with a combination of fixed and variable rate debt

- Debt service was structured to mirror the annually-increasing employer contribution schedule
- The City chose to structure its savings in the early years to mitigate an otherwise large initial jump
- Variable rate debt was issued to minimize the overall cost of funds
- The City has closely monitored its savings

Floating Rate vs. Fixed Rate



Oregon Example

Pooled Local Governments and the State Issue POBs

Since the City's financing, Multnomah County, the State and many local governments have followed suit

- Pension reform in Oregon corrected the "money match" mismatch in 2001 and provided a less costly successor plan for future employees
- Legislation was also passed which allowed for localities to form pools for the purposes of issuing pension bonds
- POBs totaling over $5.9 billion have been issued since 1999 for Multnomah County, pools of school districts, small cities and districts and the State
- As more pension paper has been issued locally and nationally, overall spreads have come down from roughly 2% over Treasuries to 1% over

Oregon Example

Lessons Learned

The Oregon case shows that a POB market can develop quickly in a state with substantive systematic issues

- Political leadership was required by the City of Portland
- A strong, credit-worthy entity can finance on its own
- The pooled approach works but primarily benefits smaller, less credit-worthy and less sophisticated issuers
- The economic benefits of this approach, though never guaranteed, have materialized for Portland

Appendix A: Detailed Savings Analysis

Appendix A: Detailed Savings Analysis

System-Wide PERS Analysis*

		NO ACTION					PROPOSED PENSION BOND SOLUTION				POTENTIAL SAVINGS	
	Salaries/ Earnings (1)	Employer Consolidated Rate (2)	Employer Past Service Rate (3)	Total Employer Contribution Rate	Adjusted Employer Contribution Rate (4)	Total Employer Payments	Employer Consolidated Rate (2)	Employer Consolidated Payments	Pension Bond Debt Service to Pre-Fund Past Svc Rate	Total Employer Payments	Decline in Employer Payments	Decline in Employer Ctb. Rate
	A	B	C	D = B + C	E = D (5% Cap)	F = A * E	G = B	H = A * G	I	J = H + I	K = F - J	L = K / A
2006	$1,527,758,000	13.24%	12.39%	25.63%	16.77%	$256,205,017	13.24%	$202,275,159	$39,257,909	$241,533,068	$14,671,949	0.96%
2007	1,593,097,000	13.32%	15.40%	28.72%	21.77%	346,817,217	13.32%	212,253,624	98,143,878	310,397,502	36,419,715	2.29%
2008	1,659,336,000	13.41%	15.86%	29.27%	26.77%	444,204,247	13.41%	222,461,646	174,383,878	396,845,524	47,358,723	2.85%
2009	1,727,274,000	13.49%	16.03%	29.52%	29.52%	509,941,444	13.49%	233,009,263	200,192,512	433,201,775	76,739,669	4.44%
2010	1,797,014,000	13.57%	16.03%	29.61%	29.61%	532,028,229	13.57%	243,914,700	208,862,512	452,777,212	79,251,016	4.41%
2011	1,868,553,000	13.66%	16.03%	29.69%	29.69%	554,765,362	13.66%	255,182,055	217,792,512	472,974,567	81,790,795	4.38%
2012	1,944,093,000	13.74%	16.03%	29.77%	29.77%	578,812,941	13.74%	267,113,078	227,232,512	494,350,890	84,462,051	4.34%
2013	2,022,803,000	13.82%	16.03%	29.86%	29.86%	603,932,863	13.82%	279,618,801	237,092,512	516,711,313	87,221,550	4.31%
2014	2,105,750,000	13.91%	16.03%	29.94%	29.94%	630,452,508	13.91%	292,839,633	247,502,512	540,342,145	90,110,363	4.28%
2015	2,193,906,000	13.99%	16.03%	30.02%	30.02%	658,674,291	13.99%	306,927,449	258,582,512	565,509,961	93,164,329	4.25%
2016	2,285,874,000	14.07%	16.03%	30.11%	30.11%	688,190,650	14.07%	321,698,668	270,172,512	591,871,180	96,319,470	4.21%
2017	2,383,053,000	14.16%	16.03%	30.19%	30.19%	719,433,468	14.16%	337,360,870	282,437,512	619,798,382	99,635,086	4.18%
2018	2,485,789,000	14.24%	16.03%	30.27%	30.27%	752,520,516	14.24%	353,976,354	295,422,512	649,398,866	103,121,650	4.15%
2019	2,594,418,000	14.32%	16.03%	30.36%	30.36%	787,567,684	14.32%	371,607,138	309,182,512	680,789,650	106,778,034	4.12%
2020	2,708,492,000	14.41%	16.03%	30.44%	30.44%	824,453,335	14.41%	390,203,414	323,662,512	713,865,926	110,587,408	4.08%
2021	2,829,672,000	14.49%	16.03%	30.52%	30.52%	863,698,066	14.49%	410,019,473	339,072,512	749,091,985	114,606,081	4.05%
2022	2,958,569,000	14.57%	16.03%	30.61%	30.61%	905,506,648	14.57%	431,162,122	355,485,357	786,647,479	118,859,169	4.02%
2023	3,095,433,000	14.66%	16.03%	30.69%	30.69%	949,975,096	14.66%	453,687,297	372,941,920	826,629,217	123,345,879	3.98%
2024	3,240,508,000	14.74%	16.03%	30.77%	30.77%	997,198,414	14.74%	477,650,879	391,480,000	869,130,879	128,067,535	3.95%
2025	3,394,392,000	14.82%	16.03%	30.86%	30.86%	1,047,381,649	14.82%	503,162,041	411,180,000	914,342,041	133,039,609	3.92%
2026	3,559,091,000	14.91%	16.03%	30.94%	30.94%	1,101,167,473	14.91%	530,541,832	432,295,000	962,836,832	138,330,641	3.89%
2027	3,733,911,000	14.99%	16.03%	31.02%	31.02%	1,158,367,623	14.99%	559,713,259	454,750,000	1,014,463,259	143,904,364	3.85%
2028	3,917,003,000	15.07%	16.03%	31.11%	31.11%	1,218,432,247	15.07%	590,422,919	478,330,000	1,068,752,919	149,679,328	3.82%
2029	4,110,532,000	15.16%	16.03%	31.19%	31.19%	1,282,057,280	15.16%	623,019,633	503,310,000	1,126,329,633	155,727,647	3.79%
2030	4,314,589,000	15.24%	16.03%	31.27%	31.27%	1,349,297,273	15.24%	657,543,364	529,705,000	1,187,248,364	162,048,910	3.76%

Total Employer Savings:	$2,575,240,971
PV of Employer Savings @ 5.80%:	$1,161,905,490
PV of Employer Savings @ 8.25%:	$876,949,570

Adjusted Employer Contribution Rate lower than Total Employer Contribution Rate due to 5% growth cap, thereby increasing unfunded liability

(1) Salaries/earnings based on 2004 Mercer PERS Report, Page 33, Table 2

(2) Consolidated Rate is an estimate based on conversation with Mercer. Needs to be validated by actuary. Does not impact potential savings from financing

(3) 2006 Past Service Rate based on 2004 Mercer PERS Report, Page 3. After 2006, Past Service Rates assume $3.4 billion unfunded liability from 2004 Mercer PERS report is amortized over 25 years (2006-2030) at 8.25%. In addition, after 2006, in years when the Total Employer Contribution Rate exceeds the Adjusted Employer Contribution Rate (due to the 5% annual cap), the resulting growth in the unfunded liability is amortized through 2030 at 8.25%

(4) 2006 and 2007 Adjusted Employer Contribution Rate based on 2004 Mercer PERS Report, Page 3. After 2006, can grow maximum 5% per year.

Please see page 10 of this presentation for important disclosure on our calculation of the numbers on this page.

Appendix A: Detailed Savings Analysis

System-Wide TRS Analysis*

		NO ACTION					PROPOSED PENSION BOND SOLUTION				POTENTIAL SAVINGS	
	Salaries/ Earnings (1)	Employer Normal Cost Rate (2)	Employer Past Service Rate (3)	Total Employer Contribution Rate	Adjusted Employer Contribution Rate (4)	Total Employer Payments	Employer Normal Cost Rate (2)	Employer Normal Cost Payments	Pension Bond Debt Service to Pre-Fund Past Srv Rate	Total Employer Payments	Decline in Employer Payments	Decline in Employer Ctb. Rate
	A	B	C	D = B + C	E = D	F = A * E	G = B	H = A * G	I	J = H + I	K = F - J	L = K / A
2006	$548,534,000	14.28%	24.57%	38.85%	21.00%	$115,192,140	14.28%	$78,330,655	$5,119,100	$83,449,755	$31,742,385	5.79%
2007	562,254,000	13.76%	29.75%	43.51%	26.00%	146,186,040	13.76%	77,366,150	25,595,466	102,961,616	43,224,424	7.69%
2008	580,874,000	13.89%	30.94%	44.83%	44.83%	260,384,026	13.89%	80,685,924	133,290,466	213,976,390	46,407,635	7.99%
2009	600,922,000	14.02%	30.94%	44.96%	44.96%	270,154,603	14.02%	84,254,490	138,290,466	222,544,956	47,609,648	7.92%
2010	622,528,000	14.15%	30.94%	45.09%	45.09%	280,679,937	14.15%	88,095,832	143,680,466	231,776,298	48,903,640	7.86%
2011	645,548,000	14.28%	30.94%	45.22%	45.22%	291,901,011	14.28%	92,195,481	149,425,466	241,620,947	50,280,064	7.79%
2012	669,523,000	14.41%	30.94%	45.35%	45.35%	303,615,211	14.41%	96,492,819	155,420,466	251,913,285	51,701,925	7.72%
2013	694,825,000	14.54%	30.94%	45.48%	45.48%	315,995,452	14.54%	101,045,681	161,755,466	262,801,147	53,194,305	7.66%
2014	721,832,000	14.67%	30.94%	45.61%	45.61%	329,219,330	14.67%	105,914,723	168,525,466	274,440,189	54,779,140	7.59%
2015	751,052,000	14.80%	30.94%	45.74%	45.74%	343,525,871	14.80%	111,181,820	175,850,466	287,032,286	56,493,585	7.52%
2016	782,222,000	14.93%	30.94%	45.87%	45.87%	358,803,098	14.93%	116,816,353	183,670,466	300,486,819	58,316,279	7.46%
2017	815,519,000	15.06%	30.94%	46.00%	46.00%	375,140,061	15.06%	122,852,619	192,035,466	314,888,085	60,251,977	7.39%
2018	850,831,000	15.19%	30.94%	46.13%	46.13%	392,493,418	15.19%	129,281,921	200,915,466	330,197,387	62,296,031	7.32%
2019	888,381,000	15.33%	30.94%	46.26%	46.26%	410,974,215	15.33%	136,146,320	210,375,466	346,521,786	64,452,430	7.26%
2020	927,943,000	15.46%	30.94%	46.39%	46.39%	430,486,365	15.46%	143,419,642	220,365,466	363,785,108	66,701,257	7.19%
2021	970,814,000	15.59%	30.94%	46.52%	46.52%	451,641,130	15.59%	151,311,914	231,195,466	382,507,380	69,133,749	7.12%
2022	1,017,069,000	15.72%	30.94%	46.65%	46.65%	474,486,447	15.72%	159,847,870	242,890,466	402,738,336	71,748,110	7.05%
2023	1,066,441,000	15.85%	30.94%	46.78%	46.78%	498,910,648	15.85%	168,998,442	255,390,466	424,388,908	74,521,740	6.99%
2024	1,119,075,000	15.98%	30.94%	46.91%	46.91%	524,993,955	15.98%	178,798,992	268,745,000	447,543,992	77,449,963	6.92%
2025	1,174,889,000	16.11%	30.94%	47.04%	47.04%	552,710,555	16.11%	189,249,077	282,930,000	472,179,077	80,531,478	6.85%
2026	1,233,515,000	16.24%	30.94%	47.17%	47.17%	581,899,292	16.24%	200,301,384	297,875,000	498,176,384	83,722,909	6.79%
2027	1,295,129,000	16.37%	30.94%	47.30%	47.30%	612,654,426	16.37%	211,995,724	313,615,000	525,610,724	87,043,701	6.72%
2028	1,359,839,000	16.50%	30.94%	47.43%	47.43%	645,038,877	16.50%	224,361,610	330,195,000	554,556,610	90,482,267	6.65%
2029	1,428,015,000	16.63%	30.94%	47.57%	47.57%	679,240,753	16.63%	237,472,686	347,705,000	585,177,686	94,063,067	6.59%
2030	1,499,757,000	16.76%	30.94%	47.70%	47.70%	715,321,312	16.76%	251,359,273	366,170,000	617,529,273	97,792,039	6.52%

Total Employer Savings:	$1,622,843,750
PV of Employer Savings @ 5.80%:	$761,146,449
PV of Employer Savings @ 8.25%:	$586,192,755

"Board Recommended Employer Contribution Rate" as provided in 2004 Mercer TRS Report

(1) Salaries/earnings based on 2004 Mercer TRS Report, Page 28, Table 2

(2) Normal Cost Rate is an estimate based on conversation with Mercer. Needs to be validated by actuary. Does not impact potential savings from financing.

(3) 2006 Past Service Rate based on 2004 Mercer TRS Report, Page 3. After 2006, Past Service Rates assume $2.2 billion unfunded liability from 2004 Mercer TRS report is amortized over 25 years (2006-2030) at 8.25%. In addition, after 2006, in years when the Total Employer Contribution Rate exceeds the Adjusted Employer Contribution Rate, the resulting growth in the unfunded liability is amortized through 2030 at 8.25%.

(4) 2006 and 2007 Adjusted Employer Contribution Rate based on 2004 Mercer TRS Report, Page 3.

* *Please see page 10 of this presentation for important disclosure on our calculation of the numbers on this page.*

Appendix A: Detailed Savings Analysis

Pension Financing Savings Calculations*

How we built to the savings calculations on the prior two pages...

- **Columns B-F:** In the "No Action" columns, we estimate what future payments would be if no pension financing occurs and the Employer Contribution Rate increases as much as necessary for employers to pay off their 2004 unfunded liabilities over 25 years.
  - See footnotes of table for specific calculation methodologies.
  - Total Employer Contribution Rate (column D) calculated by adding Consolidated/Normal Cost Rate (Column B) and Past Service Rate (column C). However, due to 5% annual growth cap in PERS Employer Contribution Rates, Adjusted Employer Contribution Rate (column E) lower in early years, thereby growing unfunded liability.
  - Total "No Action" payments calculated by multiplying Adjusted Employer Contribution Rate by Salaries.
- **Columns G-J:** In the "Proposed Pension Bond Solution" columns, we estimate what future payments would be if employers continue to make Consolidated/Normal Cost Rate payments, but replace Past Service Rate payments (amortized at 8.25%) with pension bond debt service payments (amortized at 5.80%).
  - Total "Proposed Pension Bond Solution" payments calculated by adding Consolidated/Normal Cost Rate payments and pension bond debt service.
- **Columns K-L:** Finally, in the "Potential Savings" columns, we take the expected difference in future payments and present value these savings at both the actuarial 8.25% rate and the expected bond rate of 5.80%.

** Please see page 10 of this presentation for important disclosure on our calculation of the numbers on this page.*

Appendix A: Detailed Savings Analysis

Additional Data Points to Refine Savings Calculations*

We based our savings calculations off the 2004 Mercer Actuarial Report, but had to make some assumptions on our own. To refine our calculations, we will need more information on:

- **Current Unfunded Liability Instead of 2004 Unfunded Liability:** To calculate the past service rates, we utilized unfunded liability numbers (from the Mercer report) as of June 30, 2004, and amortized these liabilities from 2006-2030. Of course, the "current" unfunded liability will change when the next actuarial report is released.

- **Future Salaries/Earnings:** We pulled future employer salaries from Table 2 of the 2004 Mercer PERS and TRS reports (page 33 in PERS report and page 28 in TRS report).

- **Expected Future Consolidated/Normal Cost Rate:** Future consolidated/normal cost rates are based on a conversation we had with Mercer, but would need to be further validated by an actuary. That said, consolidated/normal cost rates do not impact pension bond savings calculations since they are the same for both "No Action" and "Proposed Pension Bond Solution" cases.

- **Credit of the Bonds:** We have assumed insured, A1 underlying rated bonds with a reserve fund equal to average annual debt service (funded with a surety policy).

* *Please see page 10 of this presentation for important disclosure on our calculation of the numbers on this page.*

Appendix B: Copy of House Bill No. 278

HOUSE BILL NO. 278

IN THE LEGISLATURE OF THE S .TE OF ALASKA

TWENTY-FOURTH LEGISLATURE - FIRST SESSION

BY REPRESENTATIVE HAWKER

Introduced: 4/19/05
Referred: State Affairs, Finance

A BILL

FOR AN ACT ENTITLED

"An Act relating to the Alaska Municipal Bond Bank Authority; permitting the Alaska Municipal Bond Bank Authority or a subsidiary of the authority to assist state and municipal governmental employers by issuing bonds and other commercial paper to enable the governmental employers to prepay all or a portion of the governmental employers' shares of the unfunded accrued actuarial liabilities of retirement systems and authorizing governmental employers to contract with and to issue bonds, notes, or commercial paper to the authority or its subsidiary corporation for that purpose; and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

*** Section 1.** AS 44.85.010 is amended to read:

Sec. 44.85.010. Legislative policy. (a) It is the policy of the state <u>to</u>

(1) [TO] foster and promote by all reasonable means the provision of

adequate capital markets and facilities for borrowing money by municipalities in the state to finance capital improvements or for other authorized purposes, to assist these municipalities in fulfilling their capital needs and requirements by use of borrowed money within statutory interest rate or cost of borrowing limitations, to the greatest extent possible to reduce costs of borrowed money to taxpayers and residents of the state, and equally to encourage continued investor interest in the purchase of bonds or notes of municipalities as sound and preferred securities for investment;

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

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

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

(b) The legislature further declares that

(1) the exercise of the powers of the state in the interest of its municipalities **and in the interest of public employees of the state and of its municipalities** is required to further and implement the policies declared in (a) of this section by authorizing the creation of a state bond bank authority as a body corporate and politic that will have full powers to borrow money and to issue its bonds and notes

to make capital funds available for borrowing by municipalities **and for borrowing by or on behalf of governmental employers, by authorizing governmental employers to contract with the bond bank authority or with a subsidiary created under AS 44.85.085 for the purpose of reducing future costs of providing retirement and other benefits to employees,** and by granting broad powers to the bond bank authority to carry out the declared policies, which are in the public interest of the state and its taxpayers and residents:

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

(3) the bond bank authority should conduct its operations to provide the lowest rates in terms of borrowing to municipalities **and to governmental employers** as is consistent with a self-supporting operation with no expectation of subsidization with state funds; the legislature does not intend that the bond bank authority be utilized as a means to finance municipalities **or governmental employers** beyond their capability to meet repayment schedules and debt service requirements of bonds**, notes, commercial paper, or contractual obligations to the bond bank authority** [OR NOTES].

*** Sec. 2.** AS 44.85.080 is amended to read:

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

(1) sue and be sued;

(2) adopt and alter an official seal;

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

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

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

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

(7) subject to AS 44.85.100(b), borrow money and issue its negotiable

bonds or notes and provide for and secure their payment, provide for the rights of their holders and purchase, hold and dispose of any of its bonds or notes;

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

(9) accept gifts or grants from the United States, or from any governmental unit or person, firm, or corporation, carry out the terms or provisions or make agreements with respect to the gifts or grants, and do all things necessary, useful, desirable, or convenient in connection with procuring, accepting, or disposing of the gifts or grants;

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

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

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

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

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

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

(16) charge for its costs and services in review or consideration of a

proposed loan to a political subdivision or purchase by the bond bank authority of municipal bonds of the political subdivision, whether or not the loan is made or the municipal bonds purchased;

(17) fix and establish terms and provisions with respect to a purchase of municipal bonds by the bond bank authority, including date and maturities of the bonds, provisions as to redemption or payment before maturity, and any other matters which in connection with the purchase are necessary, desirable, or advisable in the judgment of the bond bank authority;

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

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

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

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

*** Sec. 3.** AS 44.85 is amended by adding new sections to read:

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

(1) providing financial and other assistance to governmental employers to enable the governmental employers to reduce their costs of providing retirement

and other benefits to their employees by prepaying all or a portion of their shares of the unfunded accrued actuarial liabilities of retirement systems;

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

(3) performing other duties and providing other services as the subsidiary corporation considers necessary or desirable to further the purposes set out in (1) and (2) of this subsection.

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

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

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

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

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

(2) to incur debt in furtherance of its purposes in the form of bonds,

notes, commercial paper, or other forms as the subsidiary corporation considers appropriate;

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

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

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

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

* **Sec. 5.** AS 44.85.180(a) is amended to read:

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

(1) the purchase of municipal bonds;

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

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

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

(5) assisting governmental employers to prepay all or a portion of their share of the unfunded accrued actuarial liabilities of retirement systems, with security as the bond bank authority considers reasonable.

*** Sec. 6.** AS 44.85.180(c) is amended to read:

(c) Notwithstanding the provisions of (a) and (b) of this section, the total amount of bond bank authority bonds and notes outstanding at any one time [, EXCEPT BONDS OR NOTES ISSUED TO FUND OR REFUND BONDS OR NOTES,] may not exceed $500,000,000. **This subsection does not apply to (1) bonds or notes issued to fund or refund bonds or notes; (2) bonds, notes, commercial paper, and other obligations issued under AS 44.85.086 or 44.85.180(a)(5).**

*** Sec. 7.** AS 44.85.410(a)(5) is amended by adding a new paragraph to read:

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

*** Sec. 8.** This act takes effect immediately under AS 01.10.070(c).

Disclaimers

Merrill Lynch prohibits (a) employees from, directly or indirectly, offering a favorable research rating or specific price target, or offering to change such rating or price target, as consideration or inducement for the receipt of business or for compensation, and (b) Research Analysts from being compensated for involvement in investment banking transactions except to the extent that such participation is intended to benefit investor clients.

This proposal is confidential, for your private use only, and may not be shared with others (other than your advisors) without Merrill Lynch's written permission, except that you (and each of your employees, representatives or other agents) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of the proposal and all materials of any kind (including opinions or other tax analyses) that are provided to you relating to such tax treatment and tax structure. For purposes of the preceding sentence, tax refers to U.S. federal and state tax. This proposal is for discussion purposes only. Merrill Lynch is not an expert on, and does not render opinions regarding, legal, accounting, regulatory or tax matters. You should consult with your advisors concerning these matters before undertaking the proposed transaction.

Ian Laing

From: Brad Fluetsch [bjf@gci.net]
Sent: Tuesday, January 17, 2006 8:28 AM
To: Rep. Paul Seaton
Subject: Pension Bonds
Attachments: Bradley J Fluetsch (bjf@gci.net).vcf

Lets say you issue a 20 year bond, and then lets say time goes by. In fact lets us say 15 years.

Is it prudent to have a 60/40 asset allocation when you know that money is leaving in 5 years, or 4, 3, 2, 1? What happens if 2001 is twenty years from now?

Bradley J Fluetsch, CFA
Fluetsch Financial Services, LLC

Ian Laing

From: Brad Fluetsch [bjf@gci.net]
Sent: Tuesday, January 17, 2006 7:30 AM
To: Rep. Paul Seaton
Subject: Pension Bonds
Attachments: Bradley J Fluetsch (bjf@gci.net).vcf

I have been thinking about the pension bond issue and this is something I would make those professionals do for you as Chairman.

E(r) is the expected return 8.25% with an expected standard deviation of 16%. To achieve that, a 60% stock, 40% bond portfolio is used.

Add pension bonds to the equation where the proceeds are invested 100% into the stock market having no defense to your question why would I put proceeds into the bond market and guarantee a loss.

Now remodel the portfolio to earn 8.25%? You will be surprised at the answers.

Don't re-balance the portfolio and your expected return goes up to over 10% with a standard deviation ballooning well over 20%. A pension bond in the portfolio mix acts as a bond allocation reducer to the extent the cash flows and interest rates are comparable. Add a pension bond subtract Lehman Aggregate exposure. Investment the proceeds into the equity market, is going all in, in Texas Hold-em with a pair of 8's.

One other thought. I just wonder about the decision makers in Alaska. It was bad decisions by the pension board that has us in this mess and look at who made the board up? I think there is a law against giving loading pistols to children to play with.

Bradley J Fluetsch, CFA
Fluetsch Financial Services, LLC

HOUSE BILL NO. 278

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-FOURTH LEGISLATURE - FIRST SESSION

BY REPRESENTATIVE HAWKER

Introduced: 4/19/05
Referred: State Affairs, Finance

A BILL

FOR AN ACT ENTITLED

"An Act relating to the Alaska Municipal Bond Bank Authority; permitting the Alaska Municipal Bond Bank Authority or a subsidiary of the authority to assist state and municipal governmental employers by issuing bonds and other commercial paper to enable the governmental employers to prepay all or a portion of the governmental employers' shares of the unfunded accrued actuarial liabilities of retirement systems and authorizing governmental employers to contract with and to issue bonds, notes, or commercial paper to the authority or its subsidiary corporation for that purpose; and providing for an effective date."

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*** Section 1.** AS 44.85.010 is amended to read:

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

(1) [TO] foster and promote by all reasonable means the provision of

New Text Underlined [DELETED TEXT BRACKETED]

adequate capital markets and facilities for borrowing money by municipalities in the state to finance capital improvements or for other authorized purposes, to assist these municipalities in fulfilling their capital needs and requirements by use of borrowed money within statutory interest rate or cost of borrowing limitations, to the greatest extent possible to reduce costs of borrowed money to taxpayers and residents of the state, and equally to encourage continued investor interest in the purchase of bonds or notes of municipalities as sound and preferred securities for investment;

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

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

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

(b) The legislature further declares that

(1) the exercise of the powers of the state in the interest of its municipalities **and in the interest of public employees of the state and of its municipalities** is required to further and implement the policies declared in (a) of this section by authorizing the creation of a state bond bank authority as a body corporate and politic that will have full powers to borrow money and to issue its bonds and notes

to make capital funds available for borrowing by municipalities **and for borrowing by or on behalf of governmental employers, by authorizing governmental employers to contract with the bond bank authority or with a subsidiary created under AS 44.85.085 for the purpose of reducing future costs of providing retirement and other benefits to employees,** and by granting broad powers to the bond bank authority to carry out the declared policies, which are in the public interest of the state and its taxpayers and residents;

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

(3) the bond bank authority should conduct its operations to provide the lowest rates in terms of borrowing to municipalities **and to governmental employers** as is consistent with a self-supporting operation with no expectation of subsidization with state funds; the legislature does not intend that the bond bank authority be utilized as a means to finance municipalities **or governmental employers** beyond their capability to meet repayment schedules and debt service requirements of bonds**, notes, commercial paper, or contractual obligations to the bond bank authority** [OR NOTES].

*** Sec. 2.** AS 44.85.080 is amended to read:

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

(1) sue and be sued;

(2) adopt and alter an official seal;

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

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

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

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

(7) subject to AS 44.85.100(b), borrow money and issue its negotiable

bonds or notes and provide for and secure their payment, provide for the rights of their holders and purchase, hold and dispose of any of its bonds or notes;

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

(9) accept gifts or grants from the United States, or from any governmental unit or person, firm, or corporation, carry out the terms or provisions or make agreements with respect to the gifts or grants, and do all things necessary, useful, desirable, or convenient in connection with procuring, accepting, or disposing of the gifts or grants;

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

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

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

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

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

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

(16) charge for its costs and services in review or consideration of a

proposed loan to a political subdivision or purchase by the bond bank authority of municipal bonds of the political subdivision, whether or not the loan is made or the municipal bonds purchased;

(17) fix and establish terms and provisions with respect to a purchase of municipal bonds by the bond bank authority, including date and maturities of the bonds, provisions as to redemption or payment before maturity, and any other matters which in connection with the purchase are necessary, desirable, or advisable in the judgment of the bond bank authority;

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

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

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

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

* **Sec. 3.** AS 44.85 is amended by adding new sections to read:

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

(1) providing financial and other assistance to governmental employers to enable the governmental employers to reduce their costs of providing retirement

and other benefits to their employees by prepaying all or a portion of their shares of the unfunded accrued actuarial liabilities of retirement systems;

(2) receiving payments and providing servicing for payments to or from participating governmental employers: and

(3) performing other duties and providing other services as the subsidiary corporation considers necessary or desirable to further the purposes set out in (1) and (2) of this subsection.

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

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

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

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

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

(2) to incur debt in furtherance of its purposes in the form of bonds,

notes, commercial paper, or other forms as the subsidiary corporation considers appropriate;

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

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

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

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

* **Sec. 5.** AS 44.85.180(a) is amended to read:

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

(1) the purchase of municipal bonds,

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

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

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

(5) assisting governmental employers to prepay all or a portion of their share of the unfunded accrued actuarial liabilities of retirement systems, with security as the bond bank authority considers reasonable.

* **Sec. 6.** AS 44.85.180(c) is amended to read:

(c) Notwithstanding the provisions of (a) and (b) of this section, the total amount of bond bank authority bonds and notes outstanding at any one time [, EXCEPT BONDS OR NOTES ISSUED TO FUND OR REFUND BONDS OR NOTES,] may not exceed $500,000,000. **This subsection does not apply to (1) bonds or notes issued to fund or refund bonds or notes; (2) bonds, notes, commercial paper, and other obligations issued under AS 44.85.086 or 44.85.180(a)(5).**

No debt limit

* **Sec. 7.** AS 44.85.410(a)(5) is amended by adding a new paragraph to read:

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

* **Sec. 8.** This act takes effect immediately under AS 01.10.070(c).

Nothing in the bill exempts political subdivisions from constitutional vote requirement of Jan 5, 06 legal opinion from leg legal – Tam Cook & Ray Weyhrauch "ratified by a majority vote of those qualified & voting and voting on the question"

An Introduction to

Pension Obligation Bonds

ROGER L. DAVIS

ORRICK

ABOUT THE AUTHOR

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

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

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

Published by
Orrick, Herrington & Sutcliffe LLP

TABLE OF CONTENTS

CHAPTER ONE

Introduction

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

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

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

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

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[1] Rankings for securities transactions of various types are performed annually by Thomson Financial, which has ranked Orrick number one in the country as bond counsel since prior to 1990. In an average year, Orrick handles more than 200 bond issues, aggregating more than $20 billion.

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

CHAPTER TWO

Pension Obligations

Pension obligations generally fall into two categories:

A. Unfunded Accrued Actuarial Liability (UAAL)

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

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

B. Normal annual contribution

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

CHAPTER THREE

Reasons For Issuing POBs

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

A. Interest Rate Savings

As described in Chapter Two, most pension systems assign an interest component to the payments the state or local government is required to make in respect of its UAAL. Assigned interest rates currently generally range from 7½% to 8½% depending on the particular pension system. When taxable bond rates are low, and as of fall 2003 they are roughly 5.95% or less for 30 year debt, then POBs can function like a classic interest rate savings refunding. For example, if the assigned rate is 7.5% on a UAAL of $100,000,000, the annual all in cost would be roughly $8,500,000 assuming a 30 year amortization, compared to an all in cost of $7,300,000 on POBs amortized over the same period assuming a 5.95% interest rate and costs of issuance of 1%. These savings to a degree can be front loaded or otherwise structured to occur when most needed (see Section C of Chapter 5).

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

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

B. Discounts

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

C. Arbitrage

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

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

D. Budget Relief

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

(1) reamortizing the UAAL by replacing the obligation to the pension fund with POBs having a longer term and/or lower payments in the early years (or even no debt service in the early years if capital appreciation bonds (CABs) or capitalized interest is used); and/or

(2) funding the normal annual contribution for the current (and maybe the next) fiscal year (to the extent permitted by applicable state law).

E. Labor Relations Benefits

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

F. Better Than The Alternatives

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

CHAPTER FOUR

Possible Disadvantages of POBs

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

A. In some jurisdictions, a state or local government may negotiate or even unilaterally make changes in its pension obligation, perhaps by postponing payments or changing assumptions. POBs replace this potentially flexible pension obligation with a more immutable bond obligation.

B. As explained in Chapter 3, while unlikely, it is possible that the assigned interest rate will drop below the bond interest rate or that the pension fund will have negative earnings, in each case for a sustained period.

C. If the pension fund enjoys higher than expected earnings, the pension fund may become overfunded and result in temporary contribution holidays, but also can lead to increases in retirement benefits that may be costly to sustain at some point in the future.

D. POBs result in payment to and investment by the pension fund of a lump sum amount that otherwise would have been paid and invested in increments over a period of years, concentrating rather than spreading market timing risks.

E. Almost all POBs are taxable and most taxable bonds with fixed interest rates are sold as noncallable bonds. Adding a redemption feature will ordinarily result in a materially higher interest rate cost than the same redemption feature in tax-exempt bonds. Therefore, taxable noncallable bonds may be expensive to refund or defease, although there have been a number of successful tender offer refundings of taxable POBs (that is, a tender offer was made for the prior bonds and the tender price was paid with proceeds of new refunding bonds).

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

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

CHAPTER FIVE

Types of POBs

A. Security

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

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

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

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

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

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

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

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

B. Credit Ratings/Borrowing Capacity

Because POBs replace existing pension obligations, they are not generally viewed as adding to the debt burden of the state or local government issuer (much like a conventional refunding).[1] To quote the rating agencies:

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

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

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

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

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

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

C. Structures

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

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

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

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

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

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

5. ***Capital appreciation bonds.*** Capital appreciation bonds (CABs) are bonds that bear no current interest, which instead is accrued, compounded (usually semiannually) and paid at the maturity of the bonds. They are used primarily to reduce debt service in the early years. A variation is convertible CABs, that function as CABs for several years and then convert on a certain date to current interest bonds (with interest paid on the then accrued value of the bonds, being the original principal amount plus the amount of accrued, compounded interest up to the conversion date). The disadvantage of CABs is that higher rates of interest are required in order to market them.

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

D. Payments to the Pension Fund: Whole or Part

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

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

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

CHAPTER SIX

Tax Issues

A. Taxable Bonds

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

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

B. Tax-Exempt POBs Prior to 1986 Tax Act

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

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

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

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

C. Tax Reform Act of 1986; Transition Rules

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

2. ***Transition Rules for Refundings of POBs.*** The status of refundings of pre-1986 Tax Act POBs was not specifically addressed in the 1986 Tax Act. In connection with two later tax acts, the Technical Corrections Bill of 1988 and Technical and Miscellaneous Revenue Act of 1988, Congress attempted to clarify its position on refundings. While the statutory language and legislative history are a bit confused, the related House, Senate, and Conference Committee Reports indicate that Congress intended generally to permit one advance refunding of pre-September 25, 1985 POBs (at least where the amount of the refunding is not greater than the amount of prior bonds). Additionally, the legislative history indicates that Congress intended to permit any number of current refundings of pre-September 25, 1985 POBs where the refunding bonds do not additionally burden the tax-exempt market, but merely replace existing tax-exempt debt.

D. Columbus Case

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

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

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