NHAlert

Side Fund Pension Bond Savings No Longer Guaranteed

Spring 2015

Following extensive discussions with leading pension experts and CalPERS representatives, it has been revealed that the implied savings from issuing side fund pension obligation bonds ("POBs") are no longer guaranteed. This NHAlert highlights some of the new risks and opportunities for CalPERS participants considering the issuance of POBs to extinguish their Unfunded Actuarial Liability ("UAL").

Background

Prior to 2014, side fund risk pool agencies could pay off their side fund UAL using POBs and essentially lock-in savings from the interest rate differential between CalPERS' 7.5% discount rate and the lower interest rate on POBs (often less than 4%). This savings was, in effect, guaranteed because the additional investment risk associated with this upfront deposit was spread amongst all agencies in the risk-sharing pool, thus, negating any significant direct impact from investment gains/losses on one participant's account.

Recent Changes to Side Fund Agencies

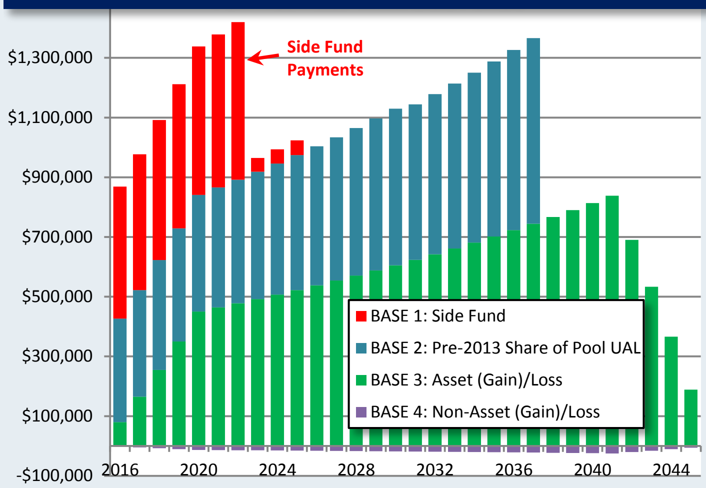
CalPERS' new policy is to credit investment gains and losses directly to that participant, rather than spread these gains and losses among pool agencies. This policy change aligns CalPERS' treatment of upfront deposits to pay off side funds with its treatment of upfront deposits for non-side fund UALs.

As a result, any POB that is issued to extinguish all or part of a participant's UAL will generate present value savings only if CalPERS earns an investment return greater than the interest rate paid on the POBs. As such, absent any other considerations such as restructuring the POB debt to achieve enhanced budget predictability, NHA recommends that a side fund participant consult with a qualified investment advisor before embarking on a POB transaction with the sole purpose of speculating that the issuer will secure positive interest savings.

POB as a Budget "Smoothing" Tool

Almost every single agency with a side fund UAL also has three additional components (called "bases") that comprise the remainder of an agency's total UAL. Since the side fund portion is amortized over a much shorter period of time (typically less than 10 years) than the other bases, there usually exists a near term "peak" in overall UAL payments, followed by a "dip" in payments. This dynamic can be seen in the chart below, with the side fund base shown in red, and the remaining three bases shown in blue, green and yellow.

TYPICAL AMORTIZATION OF UNFUNDED ACCRUED LIABILITY (UAL) FOR AGENCIES WITH SIDE FUNDS



One potentially useful benefit of issuing a POB is the ability to restructure a participant's payment stream to create a more level "shape" that removes this near term "peak and dip" in payments.

It should be reiterated that this strategy still carries the additional market timing risks of a lump sum deposit as discussed above.

Advise Researching CalPERS Changes

Whether you are a participant in a risk-sharing pool or non-risk sharing pool, NHA stands ready to share any information we have gathered, assist you in better understanding your CalPERS reports, and provide additional analysis with respect to your specific needs. Additionally, NHA recommends that you contact your CalPERS actuary representative or an actuary who is knowledgeable of CalPERS matters and recent policy changes. Finally, NHA encourages you to become familiar with the CalPERS policy changes (link to CalPERS agenda item 5):

https://www.calpers.ca.gov/page/about/board/board-meetings/financeadmin-201405

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