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Reasons and Risks: Pension Obligation Bonding in Michigan

Policy Brief

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Introduction

Per Article IX § 24 of the Michigan Constitution, past accrued pension benefits are protected and the state and local governments are contractually obligated to provide these benefits.[1] Once an employee becomes vested in her employer's defined benefit pension plan ("DB"), the employer cannot take those benefits away. DB pension plans are funded by both employer and employee contributions that are then invested. Pension plan investment portfolios have traditionally tended to be heavily weighted in lower risk and lower return assets. Because traditional investments are not yielding desired returns, in recent years, pension portfolios have taken on more risk with investments that have greater potential returns. Pension fund managers, employers, and employees want to know there will be enough assets in the fund to cover accrued pension benefit payments. Michigan's municipal governments (i.e. townships, cities, and villages) and counties have a limited number of revenue raising tools to use to meet their contribution obligations. One tool recently made available to Michigan local units is the ability to issue pension obligation bonds.

Pension obligation bonds (POBs) "may offer cost savings if the bond proceeds are invested, through the pension fund, in assets that realize a return higher than the cost of the bond."[2] However, if the return is not higher than the cost of the bond, the municipality or county will need to decide how to pay back bondholders in addition to pension payments. Additionally, POBs are issued to finance pension systems and financing is not the same as funding.[3] The underlying issues leading to large unfunded pension liabilities still exist and the local governments will need to address them at some point. Pension obligation bonding impacts more than just public sector employees and employers. It also impacts taxpayers because bonding directly influences the rest of the local unit's operating budget. Consequently, issuing POBs to finance unfunded pension liability can effect taxes as well as public services.[4]

This policy brief will explore pension obligation bonding in the United States as well as in Michigan specifically and will discuss:

- Michigan law regulating local government pension obligation bonding, including Act 34 of 2001, the Revised Municipal Finance Act.
- The reasons Michigan local governments issue pension obligation bonds, including to save money, increase fiscal responsibility, and provide short-term budget relief.
- Various risks associated with pension obligation bonding, such as investment risk, political risk, and flexibility risk, and the way these risks manifest in Michigan.
- Policy considerations to make pension obligation bonding less risky and more likely to produce positive results for all parties involved.

Michigan Law—Pension Obligation Bonds

Since the 1980s, states and local governments have used POBs to finance pension and retiree health care benefits. In October 2012, Public Act 329 added section 518 to Michigan Act 34 of 2001, the Revised Municipal Finance Act ("Act"), permitting municipalities and counties to issue general obligation bonds to pay for unfunded pension or retiree health care costs.[5] Section 518 also lays out conditions a municipality

1 MI Const. art. IX, § 24:
"The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby."
2 Alicia H. Munnell, "An Update on Pension Obligation Bonds," Number 40 Center for Retirement Research at Boston College July 2014.
3 There is a difference between a fully funded pension system and a fully funded pension system financed by POB proceeds. "Borrowing to invest in financial assets is a distinctly different type of financial operation from investing free cash flows, or borrowing for capital improvements." James B. Burnham, Risky Business? Evaluating the Use of Pension Obligation Bonds, Government Finance Review June 2003, at 14.
4 "The oft-stated intent of POBs is to reduce the burden of annual pension system payments and avoid diverting resources from core service areas." Thad D. Calabrese & Todd L. Ely, Pension Obligation Bonds and Government Spending, 33 Public Budgeting & Finance 43-65 (2013).
5 MCL § 141.2518 (2017).

or county must meet in order to issue a POB.[6] The local government must have a credit rating of AA- or higher. The pension system for which the municipality or county wishes to bond must be a closed system, meaning no new employees can be added to that pension.[7] While the bond is outstanding, benefits cannot be increased; still, local governments "may reduce benefits of the defined benefit plan for years of service that accrue after the issuance of municipal securities under [Section 518]." [8]

The most recent legislative action regarding POBs occurred earlier this year. In February 2017, Bill 4275 was introduced in the Michigan House of Representatives to amend Section 518. This amendment would allow more local governments to bond by lowering the credit rating requirement to bond from AA- to A. The bill has been referred to the Committee on Local Government and no further action has taken place. However, considering the current focus on pension reform and state and local government unfunded pension liability, legislators will likely introduce more POB legislation in the near future.

Reasons to Bond

Local governments issue POBs for various reasons, including to save money, provide budget relief, and increase fiscal responsibility.[9] The Center for Retirement Research found that a local government is more likely to issue a POB if a large portion of the local unit's budget goes toward pension obligations and there is a lack of revenue.[10] One needs to keep in mind, bonding changes the nature of the pension liability debt. Generally, this change turns a relatively "flexible" pension obligation into a more "inflexible" type of debt obligation, ensuring the debt "will be paid in a timely fashion strengthening the fiscal health of the pension system."[11] For revenue constrained local governments, this option could provide short-term fiscal clarity.

Michigan local units are required to make their annual pension payments. They are also responsible for paying down their unfunded pension liability. For many local units, these payments take up a significant and growing portion of their general fund budgets. To meet these fiscal demands, some local units are increasing employee contributions, which can negatively impact employee morale, and others are increasing taxes, which may make the municipality less competitive and encourage taxpayers to leave the area. Even more constraining is that some municipalities and counties have raised taxes to the legal limit. Instead of cutting public services in order to pay promised retirement benefits, bonding can be an attractive option.

At a minimum, POBs provide short term fiscal relief by financing some or all of a local unit's unfunded pension liability. POB bonding can lessen the burden on the local unit's general fund and, thus, its current taxpayers, without significant increases in employee contributions or taxes. For the decision to bond to be fiscally beneficial in the long term, the local unit's pension liability and its annual required contribution (ARC)[12] would need to be reduced more than is paid in principal and interest on the POB.

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6 MCL § 141.2518(1) (2017):
"In connection with the partial or complete cessation of accruals to a defined benefit plan or the closure of the defined benefit plan to new or existing employees, and the implementation of a defined contribution plan…a county, city, village, or township `may by ordinance or resolution of its governing body, and without a vote of its electors, issue a municipal security under this section to pay all or part of the costs of the unfunded pension liability for that retirement program provided that the amount of taxes necessary to pay the principal and interest on that municipal security, together with the taxes levied for the same year, shall not exceed the limit authorized by law."

7 Leon Hank, "To Bond or Not to Bond: Is That Your Question," presentation, at https://www.mersofmich.com/Portals/0/Assets/PageResources/Events/AnnualMeeting/2016/To%20Bond%20or%20Not%20to%20Bond.pdf.

8 MCL § 141.2518(9) (2017).

9 See Alicia H. Munnell, "An Update on Pension Obligation Bonds," Number 40 Center for Retirement Research at Boston College July 2014; see also Allan Beckmann, "Pension Obligation Bonds: Are States and Localities Behaving Themselves or Do the Feds Need to Get Involved?" Spring 2010.

10 Alicia H. Munnell, "An Update on Pension Obligation Bonds," Number 40 Center for Retirement Research at Boston College July 2014.

11 Allan Beckmann, "Pension Obligation Bonds: Are States and Localities Behaving Themselves or Do the Feds Need to Get Involved?" Spring 2010.

12 A local unit's annual required contribution (ARC) is the unit's normal cost plus the unit's unfunded actuarial accrued liabilities (UAAL).

Risks, In General and In Michigan

Pension obligation bonding is not risk-free. In general, there is political risk, flexibility risk, and investment risk. In addition, there exists an "intergenerational risk and cost transfer imposed by POBs by current taxpayers on future taxpayers," with the risk transferred from the government and current taxpayers to future taxpayers.[13] Some of these risks are not as pronounced in Michigan as they are in other states due to legal constraints dictating the conditions under which a government can issue POBs.

Generally, changing the nature of pension liability into debt payments creates a flexibility risk. Pension liabilities need to be paid; even so, "while debt payments are a non-negotiable portion of a government's budget, some people will advocate deferring pension payments into the future because the penalty for not making pension payments is vague and distant."[14] By changing the nature of the pension liability into a less "flexible" debt, a local unit must be fiscally responsible in order to pay the "inflexible" obligation. On the other hand, changing the nature of the pension liability debt to a less "flexible" debt reduces the government's financial flexibility, especially during times of fiscal stress.

In Michigan, local governments are constitutionally required to make ARC payments to fund pension systems, making these payments fairly "inflexible." By law, there is no "deferring pension payments into the future."[15] Even so, ARC payments are possibly more "flexible" than fixed POB annual payments. Failure to make an annual POB payment will trigger bondholders to sue the local government. Most Michigan pension systems are part of the Municipal Employees' Retirement System (MERS). While MERS can apply a penalty to a local government for failing to make its ARC payment, MERS works with the local government to try to prevent that from happening in the first place; a bondholder may not have this same kind of relationship with the municipality.

Also, local units are blocked from refunding (i.e. refinancing) for 10 years. Local governments are locked in, which hamstrings their ability to "call a bond" and, should rates fall, refinance at a lower interest rate and benefit from a more advantageous deal. Under the right circumstances, bonding can produce good results; however, one of those conditions is that "the issue should be callable, since in an environment of low inflation, low pension fund returns are likely to be correlated with low interest rates, and the opportunity to refinance a higher cost pension bond should not be forfeited."[16] By restricting the ability to call bonds, Michigan local units are deprived of an opportunity to achieve positive results.

Generally, there are political risks to issuing POBs. A pension system fully funded by POB proceeds can "create the political risk that unions and other interest groups will call for benefit increases."[17] Michigan local governments can only issue POBs for closed pension systems and are prohibited from increasing benefits while the bond is outstanding, eliminating the political risk.

Be that as it may, a Michigan municipality could lessen its political risk without closing the system. Per the Act, "[i]f a county, city, village, or township has issued a municipal security under this section, that county, city, village, or township shall not change the benefit structure of the defined benefit plan if the defined benefit plan is undergoing the partial cessation of accruals."[18] The law is written such that the elimination of political risk is tied to whether or not the system is closed. It does not appear as though there is much preventing the legislature from revisiting the law and changing it to state "[i]f a county, city, village, or township has issued a municipal security under this section, that county, city, village, or township shall

13 Thad Calabrese, Public Pensions, Public Budgets, and the Risks of Pension Obligation Bonds, Society of Actuaries (2010).
14 Allan Beckmann, Pension Obligation Bonds: Are States and Localities Behaving Themselves or Do the Feds Need to Get Involved?, Student Paper, University of North Carolina at Chapel Hill (2010).
15 Id.
16 James B. Burnham, Risky Business? Evaluating the Use of Pension Obligation Bonds, Government Finance Review June 2003, at 16.
17 Alicia H. Munnell, "An Update on Pension Obligation Bonds," Number 40 Center for Retirement Research at Boston College July 2014.
18 MCL § 141.2518(9) (2017).

not change the benefit structure of the defined benefit plan."[19] The law acts as a shield against political risk by prohibiting an increase in benefits; prohibiting an increase in benefits need not be conditional on the closure of the DB system. One of the strongest argument for this view is there is not a similar rule for Other Post-Employment Benefit (OPEB) bonding.

Another political risk stems from the negative consequences that can result from closing a pension system. A local government may not have the political will to accept the negative reaction to closing a pension plan. If so, issuing POBs may not be a viable option.

Investment risk comes with POB issuance. The goal of issuing a POB is to invest the bond proceeds and the pension assets in order to earn more than the cost (principal and interest payments) of the bond.[20] If bonding does not produce a high enough investment return, future taxpayers may face increased taxes or decreased public services, whereas current taxpayers may see increased public services or lower taxes resulting from less annual municipal revenue being paid to pension funding.[21] According to Beckmann, governments arguing in favor of POBs state they are "cost effective because the expected return on the investments bought with the bond proceeds will exceed the cost of the debt."[22] However, because governments tend to budget on an annual basis, "current accounting practices do not create a mindset that encourages the investment risk to be properly reflected in long-term budgeting projections of the impact of a POB issue."[23] Instead, due to the short-term nature of government budgeting, there is a tendency to "shift risk to future generations" even without bonding.[24] In a similar vein, the Society of Actuaries is not supportive of POBs and states "the current state of public budgeting discounts the future by definition since it focuses only on the short-term… [which] leads governments to engage in fiscally damaging behavior, such as the issuance of pension obligation bonds that transfer risk to future generations with no compensation for this risk transfer."

Pension Obligation Bonding in Michigan

As of October 27, 2017, 14 local government in Michigan have issued POBs for unfunded pension liability: six counties, three townships, and five cities (see Chart 1). One Michigan municipality that has bonded is Bloomfield Hills, one of Michigan's wealthiest communities. The decision to bond was based on the promised amount of benefits to employees in the municipality's DB pension plan, potential cost savings from bonding, as well as "predictability of annual payments for budget purposes." Bloomfield Hills' 2016 Financial Audit Report states that issuing POBs for pension liabilities "stabilized an annual expenditure that used to fluctuate year to year based upon an actuarial report." The people involved in this bonding process were bond attorneys, department heads, as well as Union leaders.

The role of the taxpayer in pension obligation bonding is limited, however there is an opportunity for taxpayers to comment on the decision to issue POBs. One of the first steps in issuing a POB is to publish and to circulate a Notice of Intent to issue the bonds and, at that point, taxpayers may make their opinions known to local government officials.

Chart 1 shows a pattern for bonded pension funds. A year before a POB was issued, the funding ratio was below the recommended minimum rate of 80% for all but two local units. After the bond is issued, the funding ratio increases due to the additional assets. However, shortly afterward, the pension

19 Id.
20 "Spotlight on Governmental Plan Pension Obligation Bonds," BuckConsultants, Vol 38 Issue 105 (2015).
21 "Critics see [POBs] as an investment gamble, and complain that the approach saddles future taxpayers with bond repayment obligations to cover past liabilities." "Spotlight on Governmental Plan Pension Obligation Bonds," BuckConsultants, Vol 38 Issue 105 (July 22, 2015).
22 Allan Beckmann, Pension Obligation Bonds: Are States and Localities Behaving Themselves or Do the Feds Need to Get Involved?, Student Paper, University of North Carolina at Chapel Hill (2010).
23 Id.
24 Thad Calabrese, Public Pensions, Public Budgets, and the Risks of Pension Obligation Bonds, Society of Actuaries (2010).

funding ratio goes down again. This may be due to lower than projected pension fund investment returns or changes to the pension fund system assumptions (e.g., adoption of new mortality tables, life expectancy). Because the pension systems are closed, as workers retire new employee payroll contributions decline, therefore decreasing the funding level. This limitation applies to pension systems that require employee payroll contributions; some pension systems do not require employee contributions. While the investment returns on the pension assets may increase the fund ratio in the long term, the fund may continue to drop in the short term. A low funded ratio can negatively impact a local unit's credit rating and will be a flag for credit rating agencies. Moreover, pension system fiduciaries may require accelerated payment schedules in order to invest more funds, which, in turn, may result in greater returns, making pension fund systems healthier. The accelerated payment schedules apply to open and closed systems.

Conclusion

Nationally, "evidence to date suggests that the jurisdictions that issue POBs tend to be the financially most vulnerable with little control over the timing," according the Munnell. On the other hand, the Michigan Department of Treasury has to review and approve municipal POB issuance. This Treasury oversight may help Michigan municipalities and counties make a sound fiscal decision. Generally, Munnell found that the governments most likely to consider bonding for unfunded pension liabilities are governments under financial stress. In other words, "the governments that could issue a POB generally have not, while those that should not issue a POB have done so." Consequently, even though the overall market is attractive for bonding, the governments bonding across the country may be the ones least able to pay bondholders in the future. In the face of increasing legacy costs, some of Michigan's revenue constrained local governments issue POBs hoping for the potential rewards of bonding despite the long term risks.

			2005			2013			2014		
Local Government	**Bonds Issued**	**Amount**	**Total Liability**	**Value of Assets**	**Funding Ratio**	**Total Liability**	**Value of Assets**	**Funding Ratio**	**Total Liability**	**Value of As-sets**	**Funding Ratio**
Allegan County	2014	$15,060,000	$42,976,381	$33,912,208	78.9%	$60,432,440	$41,941,737	69.4%	$67,371,559	$61,597,249	91.4%
Tuscola County	2016	$6,980,000	$20,032,289	$18,804,202	93.9%	$29,531,643	$25,227,788	85.4%	$33,703,096	$26,287,968	78.0%
Tuscola County	2017	$2,475,000									
Ottawa County	2014	$29,285,000	$126,887,611	$106,312,114	83.8%	$224,197,096	$175,891,057	78.5%	$268,400,096	$223,628,359	83.3%
Saginaw County	2014	$52,005,000	$116,271,363	$87,919,362	75.6%	$142,346,636	$87,799,775	62.0%	$149,188,929	$133,962,801	89.8%
City of Holland	2015	$25,000,000	$91,642,252	$74,665,205	81.5%	$119,545,474	$81,578,217	68.2%	$132,838,542	$111,310,830	83.8%
City of Bloomfield Hills	2015	$15,860,000	$23,099,541	$14,703,966	63.7%	$31,174,095	$15,484,021	49.7%	$34,927,785	$32,192,907	92.2%
City of Madison Heights	2016	$15,250,000	$28,414,461	$24,458,557	86.1%	$37,260,900	$26,029,761	69.9%	$40,440,589	$26,035,208	64.4%
City of Grand Blanc	2016	$5,760,000	$6,596,608	$4,813,274	73.0%	$11,954,676	$8,279,447	69.3%	$14,112,144	$8,461,102	60.0%
Bloomfield Township	2013	$80,780,000	$92,970,370	$93,667,303	100.7%	$157,732,226	$127,620,304	80.9%	$203,271,702	$223,169,053	109.9%
West Bloomfield Township	2013	$7,020,750	$79,692,787	$59,493,069	74.7%	$128,071,374	$108,536,572	84.7%	$143,168,959	$120,618,404	84.3%
Shelby Township (police and fire)	2014	$9,300,000	$62,956,557	$38,357,722	60.9%	$88,915,677	$64,799,508	72.9%	$101,519,715	$93,540,234	92.1%
Crawford County	2015	$7,155,000	$10,333,498	$6,624,034	64.0%	$17,503,191	$12,346,721	70.5%	$20,507,751	$13,188,744	64.3%
Gratiot County	2016	$6,730,000	$18,725,489	$13,440,536	72.0%	$25,582,638	$19,443,117	76.0%	$29,228,761	$22,599,432	77.3%
City of Royal Oak	2017	$20,570,000	$152,016,000	$134,773,000	88.7%	$199,908,548	$125,708,944	62.9%	$206,080,854	$136,325,204	66.2%

			2015			2016		
Municipality	**Bonds Issued**	**Amount**	**Total Liability**	**Value of Assets**	**Funding Ratio**	**Total Liability**	**Value of Assets**	**Funding Ratio**
Allegan County	2014	$15,060,000	$67,371,559	$61,597,249	91.4%	$68,151,365	$60,954,708	89.4%
Tuscola County	2016	$6,980,000	$33,703,096	$26,287,968	78.0%	$34,951,562	$34,607,082	99.0%
Tuscola County	2017	$2,475,000						
Ottawa County	2014	$29,285,000	$268,400,096	$223,628,359	83.3%	$281,451,390	$230,443,173	81.9%
Saginaw County	2014	$52,005,000	$149,188,929	$133,962,801	89.8%	$148,676,653	$128,382,162	86.3%
City of Holland	2015	$25,000,000	$132,838,542	$111,310,830	83.8%	$134,463,694	$112,356,798	83.6%
City of Bloomfield Hills	2015	$15,860,000	$34,927,785	$32,192,907	92.2%	$36,697,229	$31,777,545	86.6%
City of Madison Heights	2016	$15,250,000	$40,440,589	$26,035,208	64.4%	$40,503,803	$42,484,975	104.9%
City of Grand Blanc	2016	$5,760,000	$14,112,144	$8,461,102	60.0%	$14,534,527	$14,690,100	101.1%
Bloomfield Township	2013	$80,780,000	$203,271,702	$223,169,053	109.9%	$208,236,229	$205,807,266	98.8%
West Bloomfield Township	2013	$7,020,750	$143,168,959	$120,618,404	84.3%	$149,454,148	$127,383,418	85.2%
Shelby Township (police and fire)	2014	$9,300,000	$101,519,715	$93,540,234	92.1%	$104,884,791	$97,944,531	93.4%
Crawford County	2015	$7,155,000	$20,507,751	$13,188,744	64.3%	$20,780,409	$21,721,634	104.5%
Gratiot County	2016	$6,730,000	$29,228,761	$22,599,432	77.3%	$30,003,323	$42,090,008	80.3%
City of Royal Oak	2017	$20,570,000	$206,080,854	$136,325,204	66.2%	$210,669,256	$124,994,849	59.3%

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