ILLINOIS PUBLIC PENSION FUND ASSOCIATION

An Association of Police and Fire Pension Funds

PENSION TRUSTEE NEWSLETTER

LEADING PUBLIC PENSION FUNDS THROUGH THE 21st CENTURY

OCTOBER 2007

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RETIRE AND BE HAPPY

A Retirement Survival Guide for Boomers; plus plenty of sage advice for the rest of us.

Your parents had it easy--at least when it came to retirement. Big salary increases, fat company pensions and a general frugal disposition made saving for their golden years a relative cakewalk. Retirement is going to be a whole lot more complicated for baby boomers, particularly those at the tail end of the generation. They're going to live longer and require more money than their parents. Chances are, they'll continue working after age 65, they won't have a sizable pension to rely on should they choose to stop working, and they may even have a free-loading kid to put through college, or an aging parent to support. On top of all that, they'll likely carry debt into retirement, and struggling to pay off that mortgage has left their RRSPs starved for cash.

Sounds scary, doesn't it? Certainly, a lot of the advertising around retirement planning is designed to frighten boomers into action--a fear exacerbated by a flurry of surveys indicating that Canadians are woefully unprepared to stop working. That becomes a major issue for everybody, given that boomers make up approximately one-third of Canadians, and the first wave of them turns 65 in 2011. Two-thirds of Canadians expecting to retire by 2030 are not saving enough to meet even basic living expenses, according to a study released in May by the Canadian Institute of Actuaries, which recommends everybody over 40 start contributing at least 15% of their annual gross income to an RRSP. "I don't think people really have an understanding of just how much retirement is going to cost them," says Jonathan Sceeles, a certified financial planner with Edward Jones in Toronto.

Such fear may be necessary to force Canadians into saving for retirement, but it usually turns out to be overblown. Financial planners say clients are often pleasantly surprised when they learn how much they're worth. Even the new realities of retirement--everything from declining corporate pensions to increasing debt--are not insurmountable if a plan is made in advance. There are often overlooked sources of income, strategies to mitigate risk to your portfolio and ways to leverage real estate, all of which will determine if you're financially secure enough to live your ideal retirement.

The first challenge is working up the courage to look at your finances. "There's a lot of pent-up anxiety around retirement," says Patricia Lovett-Reid, senior vice-president of TD Waterhouse. "It's simply fear of the unknown. But it's better to confront it sooner rather than later." Although Lovett-Reid sees clients who have put off retirement planning until they're 60, she recommends people start by at least 40, preferably even earlier. The goal is to establish how much income you'll need each year to live comfortably in retirement, but you shouldn't put much faith in the old rule of thumb that you'll need 70% of your current annual income. "I find it completely useless," says Ted Rechtshaffen, president and CEO of TriDelta Financial Partners in Toronto.

Each person's lifestyle and financial (Cont. on P.2)

Retire And Be Happy

(Cont. from P.1)

situations different, so blanket statements about retirement income don't have much value. Expenditures do tend to fall in retirement, but spending shifts take place gradually. Rechtshaffen says people can spend just as much in early retirement as they did before, if not more, as they treat themselves to vacations and other luxuries. Spending falls after that, but may pick up again if someone's health worsens, requiring long-term care or a permanent move to a retirement home.

Determining how much income you'll need is actually the easy part, say planners. Setting that money aside is when the problems start. Sceeles says clients are typically daunted when they find out how much of their income they have to squirrel away in an RRSP. He recommends at least 10% of your income each year by the time you're 40, but having the discipline to do so is difficult for a lot of younger boomers. "We've seen so many people 10 years older than us with a surplus of cash and a fancy lifestyle," Sceeles says. "We thought we had to mimic all that." Clients compensate by saving less money than they should each year, with the intention of increasing it later. Those increases rarely happen, Sceeles says.

Falling behind is particularly dangerous now that corporate pensions are less robust. Ten years ago, slightly less than 43% of paid workers participated in a pension plan; that number has since dropped to 38.5% and shows no sign of reversing. The nature of pensions is changing, too, with more corporations switching from a defined benefit model to a defined contribution model, putting more responsibility on the individual to contribute money to the plan. Defined contribution plans also offer little or no protection against inflation, which can eat away at a retiree's savings. Older boomers may have caught the tail end of the defined benefits era, but younger boomers aren't so lucky.

The decline in corporate pensions may be worrying, but it shouldn't throw boomers into despair. Rechtshaffen says people are too quick to discount the value of the Canada Pension Plan and old age security. A couple that has lived and worked in Canada most of their lives can pull in around $30,000 a year from these government programs alone, he says. Other financial advisers caution against relying on the government, however, and exclude CPP from clients' plans. The sheer number of boomers moving through the system at once, combined with the comparatively small number of younger Canadians making payments will put tremendous strain on the CPP and OAS. "I don't believe in making people fearful, but if you plan on that being your retirement income, you're going to be sorry if it's not there," Sceeles says.

The solution is to put more money into an RRSP or equities, depending on your age. The farther away from retirement you are, the more heavily invested your portfolio should be in growth-oriented equities. While plenty can be written about designing the perfect retirement portfolio, Lovett-Reid at TD prefers a mix of 20% in fixed income, 20% in Canadian stocks, 30% in U.S. stocks and the balance in international stocks. Regardless of a portfolio's contents, each one is subject to what financial planners call "stream of return" risk. Market performance during the two or three years surrounding a person's retirement date can have a huge impact on the value of your equity investments. Retiring during a bear market, even a modest one, can rapidly deplete your savings, because your portfolio may not be generating any positive returns, and yet you've started to draw from it. One way to reduce this risk is to gradually move money out of equities and into fixed-income products, such as RRSP, bonds or GICs. Sceeles recommends that at age 40, approximately 40% of your savings should be in fixed income and the rest in equities. The reverse should be true by age 60, so your market exposure is reduced.

Of course, savvy boomers shouldn't rely exclusively on equities--real estate is becoming an increasingly popular source of retirement revenue, and selling isn't the only way to tap into home equity. For example, a reverse mortgage allows homeowners to receive up to 40% of the home's current value, tax-free. Interest on the loan is typically paid annually and the full amount is not due until the death of the last surviving spouse, or until the homeowner moves. Given the upward trend in real estate prices, the loan should pay for itself upon the sale of the house in most cases, says Rechtshaffen. "There are a lot of people heading into retirement who have a huge amount of real estate equity and don't even consider the possibility that it's money they can use," he says.

People generally take out a reverse mortgage late in retirement, and only if absolutely necessary. That thinking will change as attitudes toward debt change, says Mike Reed, head of retirement client strategies at RBC Financial Group. "Canadians have an aversion to debt, but what we're seeing is that aversion is starting to be overcome," he says. Indeed, boomers might be a little too comfortable with debt. A Bank of Montreal study found that 68% of pre-retirees expect to carry debt into retirement. "In your 50s, you should aggressively be looking to retire debt," says Lovett-Reid. That (Cont. on P.4)

A PLAN SPONSOR'S FAQ: INDEX BENCHMARKING BASICS AND THEIR ROLE IN ASSESSING RISK AND RETURN

1. When should I start to think about the selection of benchmarks?

It is never too early! Benchmark discussion can begin as part of your pension plan's investment strategy process. The selection of appropriate benchmarks is one of the first steps in both defining and achieving a plan's investment objectives. Not all indexes are benchmarks and not all benchmarks are the same.

2. Why should I select a benchmark?

As a plan sponsor, you know the first step in plan management is creating an investment policy statement. The analysis, implementation and assessment of that policy is dependent on the selection of appropriate benchmarks for each of the broad asset classes, as well as any sub divisions of the asset classes (e.g., one sub division of U.S. equity is U.S. Large Cap Growth equity). It is crucial that benchmarks are chosen that accurately represent the asset class opportunity set and investment manager mandate.

3. How do I select a benchmark? And how do benchmarks differ?

Benchmark selection is plan-specific; even plan sponsors with nearly identical plans might not agree on the same set of benchmarks for their investment managers. However, there are four criteria that are widely used when considering an index provider:

- Market representation
- Rules/methodology
- Investability
- Turnover

Market representation—Does the benchmark effectively represent the broad asset class (say, equities) or sub asset class (say, U.S. large-cap growth equities) it is attempting to measure?

What securities are selected for inclusion in the index? What data is collected to calculate the index value? Obviously, a plan sponsor would want to select the index that represents the full set of opportunities available to their money managers.

Rules/methodology—Each index provider uses its own methodology for selecting, weighting and mapping stocks into its broad and sub asset class benchmark indexes. Differences in those methodologies can account for significant differences across index providers. There are also rules each provider has that govern the construction of the benchmark. Ask your money manager or consultant: "Is there a solid discipline in place that's also objective? Are those rules well established and public?" A benchmark built with an objective and transparent set of rules will be predictable and understandable in terms of how it represents the asset class. No investor wants surprises from their benchmark! Therefore, it's important to understand as much as possible about the philosophy, discipline and methodology of the different index providers available to you.

Investability—The benchmark index should represent securities that are available for investment. The concept of "floatadjustment" comes into play here: In a given company, there can be a significant portion of the outstanding shares (or, total float) that will not be, or is restricted from being, traded. For example, some may be held by a single individual or entity (i.e., Microsoft/Bill Gates) and there is a very good chance that those shares will not be traded. When an index is weighted by "float-adjusted" market capitalization, those closely held or restricted shares are excluded from any index calculations – which gives a true indication of what shares are actually available for trading on a given day.

Turnover—Part of index maintenance consists adjusting the securities it holds as the market changes. That maintenance includes the re-constitution and re-balancing of the index components. How often the benchmark provider maintains their products can speak to their purity and consistency of style, capitalization and relevancy.

4. I've heard about "gaps" and "overlaps" in index coverage. What does that mean?

Gaps in coverage occur when benchmarks do not adequately cover the market or there is not an "additive" relationship across sub asset classes. Simply, this means that the makeup of all the sub asset class indexes does not "add up" to the broad asset class index makeup. For example, the components of a U.S. small cap index and a U.S. large cap index are combined to form a U.S. equity index. Intuitively, this methodology would provide no "gaps" in market coverage (assuming the broader index completely covers the U.S. equity market), which makes for a more relevant, consistent comparison to a well-diversified portfolio.

Overlaps in coverage occur when style or cap benchmark components appear in conflicting benchmarks. It might seem strange that a stock can be considered both growth and value or both large cap and small cap at the same time. But some benchmarks categorize some "middle-of-the-road" stocks –stocks that are apparently not so clearly defined- into multiple categories. Take note if you are asking managers to track benchmarks that take this blended approach. You may end up with different investment managers targeting some (or many) of the same stocks, which can unknowingly increase your exposure to specific areas in the market.

5. Should I use benchmarks from multiple index providers?

It is not uncommon to use benchmarks from different index providers. However, adopting consistently maintained benchmarks from a single index provider may increase your ability to reduce the effects of benchmark overlap, missing coverage or other issues that can arise from differing methodologies. Once again, the more you know about contrasting methodologies, the better you'll be able to understand their effects on risk and return assessment.

6. How do benchmarks help me assess risk and return?

While risk can mean many things to many investors, plan sponsors view risk in terms of their ability or inability to satisfy any future plan liabilities. Benchmarks represent an excellent means to (Cont. P.7)

Retire And Be Happy

(Cont. from P.2)

might mean spending less, downsizing the house or car, or even preparing to work longer.

Quickly paying off debt isn't always possible, especially when it's a mortgage, but it is possible to pay down a mortgage while still contributing to an RRSP. Doing so depends on interest rates, mortgage rates and your own financial situation, but, says Sceeles, "You're going to get a better bang for your buck holding your mortgage as it is and putting every additional dollar into your RRSP" given today's interest rates. For each dollar you put into your RRSP, you can receive 30 cents back in tax relief, depending on your income tax bracket. "It may not make sense to pay off your mortgage too quickly," he says.

Any strategy to boost your savings heading into retirement is worth investigating, since you'll have plenty of time and financial obligations, such as caring for elderly parents. A BMO study found that 34% of boomers already provide assistance to an aging family member, and a quarter of those have had to change their retirement plans as a result. Preparing for such a possibility requires a difficult conversation with your parents about their financial situation, health and long-term care needs. You must determine the viability of a parent continuing to live at home, as well as attitudes toward in-home care, retirement residences and even moving in with you. The financial implications must also be factored into your own retirement plans. However delicate such a conversation may be, it's important to work through these issues early on. After all, your life will also be affected--where you live, your finances and your ability to keep working.

With so much focus on the financial aspects of retirement, it's easy to overlook the question of how you'll actually spend your time. Certainly, more Canadians are continuing to work after 65, either by choice or financial need. Slightly less than 60% of Canadians over 45 plan to work for an employer after retirement, usually in part-time or consulting positions. But even if you continue to work in some capacity, you'll probably have more free time than you did before. According to Desjardins Financial Security, a large majority of pre-retirees feel it's important to plan a social life after retirement, but only 55% have actually done so. "We plan for retirement like it's a 30-year long weekend," says Barry LaValley, founder of the Retirement Lifestyle Center, a research company in Nanaimo, B.C. Even your most cherished leisure activities can lose their luster after years of doing nothing else.

When pre-retirees are asked how they would like to spend retirement, travel tops the list. "They may travel for four months, but they've given no thought whatsoever to what the other eight months will look like," LaValley says. Boredom, lethargy and a sense of no longer being useful can set in, especially for go-go boomers. On the flip side, many people think they will do all of the things they never had time to do before. There are exceptions, but LaValley says most boomers will not become new people in retirement. "You are who you are from the time you're born," he says. "If you're not doing something prior to retirement, it will be extremely difficult for you to do it after retiring." That's not to say people shouldn't try new things in retirement; rather, boomers should have realistic expectations. "You're going to hear a lot more about people having a first retirement, a second retirement and maybe even a third retirement," says Lovett-Reid, who finds clients are returning to work soon after retirement, only to retire again.

There is no definitive way to deal with retirement, but LaValley says you should start thinking about the aspects of work you like (even if you don't particularly care for your job) and how to integrate them into your post-career life. The sociability of work can be found by joining clubs and community associations. Structure can be compensated for by scheduling regular appointments and activities to keep your life orderly. A loss of identity and status is particularly common for men, and while returning to the workforce is an option, so is volunteering or joining a board of directors. The answers are different for everyone, but the point is to start thinking about them to avoid floundering later on.

And don't forget to communicate your plans to your family members, especially your spouse, since they can have different priorities. Reed recalls a couple who moved to Orlando, Fla., assuming their children and grandchildren would visit. After two years, no one had made the trek south. Mistakes like that can be avoided with proper planning. No one wants a boring, lonely retirement. Even a young Paul McCartney realized that way back in the '60s when he wrote "When I'm Sixty-four," which offered a satirical vision of retirement involving knitting sweaters and Sunday morning strolls. "Doing the garden, digging the weeds / Who could ask for more?" he sang.

You'll ask for more. You just have to figure out what you'll be asking for.

1 START EARLY

The earlier you start, the more cash you'll have come retirement. The logic is simple, and yet it's a difficult rule for some. Keep in mind that the average male lives to be 76, the average female to 82, and (Cont. on P.6)

SB 65

Passed Senate:	58-0-0
Passed House:	117-0-0
Senate Concurrence:	59-0-0

Transfer of Tax Levy Proceeds to Downstate Police Funds
P.A. 94-0859, which became effective on June 15, 2006, amended the Downstate Firefighters' Article of the Illinois Pension Code to provide for the transfer of property tax proceeds to the treasurer of Downstate Fire pension funds within 30 days of receipt by the county in which the pension fund is located. SB 0065 mirrors the requirement in P.A. 94-0859 that proceeds from the pension tax levy be forwarded to the treasurer of the Downstate Police pension fund within 30 days after receipt by the county.

Transfer of Service Credits from Downstate Police Funds to SERS
Currently, any member of the State Employees' Retirement System who is an investigator for the Office of the State's Attorneys Appellate Prosecutor or a controlled substance inspector may transfer all of his or her creditable service in a Downstate Police pension fund to SERS upon payment by the Downstate Police fund to SERS in an amount equal to (1) employee contributions, (2) employer contributions, and (3) any interest paid by the applicant in order to reinstate service credit.

SB 0065 expands eligibility for such transfers to State policemen, investigators for the Secretary of State, and Conservation police officers. The bill stipulates that any person applying for a transfer of service credit may reinstate service that was terminated in a Downstate Police fund by receipt of a refund by paying to the Downstate Police fund the amount of the refund, with interest at 6% compounded annually, from the date of the refund to the date of payment.

Transfer of Service Credit from Downstate Police Funds to IMRF
P.A. 94-0356, which became effective on July 29, 2005, allowed active participants in IMRF with less than 8 years of creditable service in a Downstate Police Pension Fund to transfer that service credit to IMRF. The member must have applied in writing by January 1, 2006. Along with the service credit, employee and employer contributions were to be transferred from the Downstate Police pension fund to IMRF, including any interest on those contributions.

SB 0065 allows for a similar window for the transfer of service credit from a Downstate Police fund to IMRF until January 1, 2008. The bill also stipulates that, until January 1, 2008, an IMRF member who wishes to transfer service credit from a Downstate Police Fund may reinstate service credit that was terminated by receipt of a refund by paying to the Downstate Fund the amount of the refund with interest at 6%, compounded annually, from the date of the refund to the date of payment.

SB 1553

Passed Senate:	39-14-2
Passed House:	84-32-0

The Downstate Firefighter Article of the Pension Code currently stipulates that a disability pension shall not be paid to a firefighter until the firefighter has been examined by 3 physicians selected by the board. SB 1553 amends the Code to specify that the 3 physicians need not agree as to the existence of any disability or the nature and extent of a disability. The bill, as amended, also prohibits a municipality from using a physical or mental disability as a means of discharging a firefighter. In addition, SB 1553 stipulates that if the firefighter must file a civil action against the municipality to enforce his or her mandated return to payroll, the firefighter shall then be entitled to recover reasonable court costs and attorney's fees.

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(Cont. from P.4)

the odds of at least one member of a 65-year-old couple living until 94 are one in four. That's a lot of living to fund, so start planning by age 40.

2 MAXIMIZE YOUR RRSP

Don't wait until the end of the year to make an RRSP contribution. Monthly contributions generate higher returns than a year-end investment, but plunking down a lump sum at the beginning of the year earns even more. An annual $5,000 investment for 30 years made at the beginning of each year will be worth $45,000 more than the same amount invested at year-end, according to RBC.

3 FIND SOME GOOD HELP

Fewer young people will be in the workforce by the time you retire, and that means both the demand and price of local services (things such as lawn care or any other kind of handiwork) will increase. Not drastically, but it will be more difficult to find hired help at a time when you'll need more of it. That could impact where you live, since you'll want to be in a place where people and services are available. Retiring to a dream home way out in the country might not be so practical.

4 DON'T BANK ON DADDY

An inheritance may be another source of retirement income for younger boomers, but such a prospect is no excuse not to save. Your parents may continue to live for a long time, or require costly medical care later in life, thereby reducing whatever inheritance you were counting on.

5 DIVERSIFY YOUR INCOME

Draw income from a variety of places, including your RRSP, pensions, non-sheltered investments and, potentially, your home. The right mix depends on your individual financial situation. Remember not to overreact to a market downturn, either. A retirement portfolio should be balanced, and moving large sums of money into risky or overly conservative investments can easily backfire.

6 PLAYING CATCH-UP

The need to save doesn't always sink in, and drastic action is often necessary. Max out your RRSPs, cut back on spending, downsize your car or your house and change your lifestyle expectations. Prepare to work a little longer, too, because even one year's salary can go a long way in retirement.

7 PLANNING FOR THE UNPLANNED

Sure, you'll live longer, but not all of those years will be spent in perfect health. A serious medical setback can easily derail retirement plans, especially if healthcare costs are downloaded to the individual, because of the strain boomers will put on the public system. Any financial plan should include measures to reduce the burden of healthcare costs, such as setting aside money in a contingency fund or investing in critical illness insurance.

8 REMEMBER TO GET A LIFE

Don't put all your energy into your finances--plan for a social life, too. Just be realistic. Chances are, you won't spend all of your time traveling if you weren't a big traveler before retirement. Figure out how you want to use your time and work with a financial planner on how to achieve that lifestyle. Don't wait until you're 65 and have your savings dictate how you live.

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Please send a contact e-mail address to Member Services Representative Tony Halachoulis at thalachoulis@aol.com or call the office at 847-608-6014 ext. 11

A Plan Sponsor's FAQ: Index Benchmarking Basics and Their Role in Assessing Risk and Return

(Cont. From P. 3)

monitor how closely investment managers are tracking their mandated benchmark index, both in terms of their adherence to the mandate (risk) as well as returns.

Risk—Let's remember that your investment policy statement is your long-term plan for, well, the plan. You and your consultant have spent many hours deciding how the assets should be allocated - for proper diversification as well as to (hopefully) satisfy the future liability stream. Substantial deviation from that plan puts you at risk of NOT being able to do that. Deviation from the plan occurs when a manager does not stick to their mandate – for example, when a growth manager buys value stocks, they can create an overexposure for the plan to value that is not a part of your investment policy. Benchmarks are not, by themselves, style measurement tools. But, investment manager performance deviations (positive or negative) versus the benchmarks can alert you to manager style or cap "drift". It's important to remember that you, as a plan sponsor, can and should ask questions of your managers and consultant to thoroughly explain substantial performance deviations from the benchmarks (yes, even substantial outperformance should be questioned – did they achieve their return by drifting away from their mandate?).

Return—If the right benchmarks are chosen, they provide an easy, readily available source to measure your investment managers'performance versus an investable set of opportunities. Peer group comparisons and other measures that your consultant uses should add to your understanding of manager performance as well.

7. Is it a big deal to change/add benchmarks?
Innovations in indexing and advancements in technology occur all the time. Therefore, the opportunity to use "new and improved" benchmarks/tools for assessing risk and return becomes available for consideration. Transitioning to new or additional benchmarks is not unusual. In most cases, the transition is relatively simple. Talk to your consultant to determine the best process for adoption and implementation.

For more information on Dow Jones Indexes, please visit our Web site at www.djindexes.com, email us at cheryl.daniels@dowjones.com or call 609.520.4639.

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IPPFA REMEMBRANCE FUND

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Thomas Wood	*Maywood Police Department*	*October, 2006*
Jeremy Chambers	*Cahokia Police Department*	*April, 2006*
Stephen Zourkas	*Niles Police Department*	*April, 2005*
Daniel Figgins	*St. Charles Police Department*	*April, 2005*
Cristy Tindall	*Peoria Police Department*	*December, 2004*
Jonathan Walsh	*Joliet Police Department*	*August, 2004*
William Rolniak	*Riverdale Police Department*	*April, 2004*
Eric DeWitt	*Matteson Police Department*	*February, 2003*

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Benefactor: $1000 + **Supporter: $500 - $999** **Patron: $100 - $499** **Donor: to $99**

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UNDERSTANDING PENSION OBLIGATION BONDS

Before understanding how pension obligation bonds work, it is important to understand how pension plans are funded. The financial condition of a pension plan is measured annually by the preparation of an actuarial valuation. The actuarial valuation is based upon actuarial assumptions and a funding methodology, and the results of the actuarial valuation determine the annual plan funding needed.

The annual pension plan contribution for any given plan year can be broken down into two main components-- (1) the normal cost for the year and (2) the amount required to amortize the unfunded past service liability. The *normal cost* is the cost of benefits that accrue for members who are actively working and earning service credit during the plan year. The *unfunded past service liability* or *unfunded accrued liability* as it is more commonly known – is, in general, the present value amount of any accrued benefit obligation that is greater than the total amount of plan assets held in trust as of the valuation date. Said another way, the ongoing cost of a pension plan in any year is the cost of benefits accruing during the year plus an amount to pay down the unfunded accrued liability over some time horizon (usually 30 years, give or take). In practice, of course, there are a number of wrinkles that can complicate this basic pension funding formula. For the purposes of this article, this fundamental concept will suffice.

An Actuarial Primer

The *actuarial accrued liability* of a pension plan is the portion of the total liability that is allocated to members' past years of service. For inactive and retired members, all years of service are in the past, so their accrued liability is equal to the total liability. For members that are actively working and accruing benefits, the accrued liability represents the portion of the total liability that is attributable to the years of service that the members have already worked. As described above, the normal cost is the cost of benefits that accrue for members that are actively working and represents the anticipated growth in the accrued liability in the upcoming year for active members. The accrued liability is compared to the total value of plan assets as a measure of funding progress. See Figure 1 on page 13.

An unfunded accrued liability can arise for several reasons. The most common are:

- Actual asset performance worse than expected
- Unfavorable demographic experience, such as higher pay increases, earlier retirements, longer life expectancies
- Changes to actuarial assumptions that immediately increase liabilities on a valuation date
- Plan design changes that increase benefits related to past service.

What Are Pension Obligation Bonds?

A *pension obligation bond* is a financing instrument (or instruments) intended to relieve the issuer of some portion of its annual pension contribution. Pension obligation bonds are taxable bonds that are issued by a state or local government. Due to certain provisions of the Tax Reform Act of 1986 (which in effect was almost a rewriting of the Internal Revenue Code), pension obligation bonds are issued in an aggregate amount equal to all or some portion of the unfunded accrued liability of the pension plan. Once sold to the market, the proceeds are added to other pension trust assets and invested as part of the entire portfolio. Therefore, the plan will realized an immediate increase in *funded status* – the ratio of the actuarial value of assets to actuarial accrued liability. In the situation where the pension obligation bond issue size is equal to the entire unfunded actuarial liability, the plan's funded status will increase to 100%.

What Circumstances Have Increased the Interest in Pension Obligation Bonds?

Certain circumstances make it more attractive for a state or local government to implement pension obligation bond financing. Although pension obligation bonds were mildly popular during the mid-1990's, their use fell into hibernation (when the "bears" were in hibernation, so to speak) during the stock market bull run of the late 1990's. By the turn of the millennium, many public pension systems enjoyed funded ratios in excess of 100%. In some cases, where funded rations were well above 100%, pension boards throughout the country opted to share asset gains that had built up in trusts with members by increasing pension accruals for active employees and providing generous "13th checks" and ad hoc cost-of-living adjustments to retirees.

However, the period from 2000 through 2002 proved to be the worst three consecutive years the stock market had experienced since World War II. In addition –and something that took a lot longer to manifest into a problem –retirees have longer life expectancies than in the past, which caused (Cont. on P. 9)

Understanding Pension Obligation Bonds

(Cont. from P. 8)

increases in pension plan liabilities that were unrelated to economic conditions and only exacerbated the problem. Somewhat unusual from a pure, theoretical financial markets perspective, was that while stock markets perspective, was that while stock market performance had suffered for three straight years, interest rates had also declined and remained at historically low levels. This scenario once again opened up the door for the use of pension obligation bonds as a viable consideration to improve a plan's funded position.

Reasons for Issuing Pension Obligation Bonds

There are four main reasons why a governmental entity would issue a pension obligation bond.

1. **Interest rate savings.** Interest on a pension plan's unfunded accrued liability is 7% to 8%, depending on the pension system. Interest on taxable bonds is 5% to 6%. If the pension plan actually earns 7% to 8%, the pension obligations bond will result in cost savings. However, the unfunded actuarial liability is based on many changing factors – especially investment return – so final interest rate savings cannot be determined in advance.
2. **Arbitrage.** Pension plans usually invest in a much broader range of investments than state or local governments. Pension plans have a higher risk tolerance (due to their structure) so they can invest in more volatile markets than state or local governments can. The pension obligation bond proceeds will be invested by the pension plan and could generate higher returns than the interest cost on the pension obligation bonds. There is no guarantee that the arbitrage will be positive.
3. **Budget relief.** By issuing a pension obligation bond, the unfunded accrued liability can be reamortized by replacing the obligation to the pension plan with the pension obligation bond. Pension obligation bonds can be structured to have a longer or shorter payoff period than the amortization period of the unfunded accrued liability. In addition, pension obligation bonds can be structured to have lower payments in the earlier years.
4. **"Better" than the alternatives**. Other ways to reduce the unfunded accrued liability include increasing employer contributions, increasing member contributions, reducing benefits or hoping to earn investment returns greater than the actuarial assumed rate of return. Pension obligation bonds may be easier to institute than these alternatives.

There are many issues that need to be considered and addressed when issuing a pension obligation bond. However the actual transaction can be described in relatively simple terms. Figure 2 (on Page 13) illustrates the mechanics of a pension obligation bond transaction.

How Much of the Unfunded Accrued Liability Should Be Funded by a Pension Obligation Bond?

When retirement systems contemplate a pension obligation bond strategy today, they will often only consider funding a portion of the unfunded accrued liability, rather than the entire amount. From the standpoint of the plan sponsor, transferring pension obligation bond proceeds to pension fund managers for investment does not remove any underlying liability associated with the plan's underfunding. Instead, one form of liability (that associated with future pension payments to plan beneficiaries) is transferred to another (payments necessary to service the new debt created by the bonds).

Payments on bond debt are referred to as *hard obligations,* while contributions to pay down the unfunded accrued liability of a pension plan are *soft obligations.* If the bond debt is not paid in full and on time, the issue falls into default. The *soft* nature of unfunded accrued liability amortization means that contribution to the unfunded accrued liability can sometimes be deferred or reduced without such serious negative results. Additionally, if pension obligation bonds are issued such that the funded ratio increases to 100% and solid investment performance pushes the funded ration higher, there is pressure to distribute the surplus in the form of benefits increases, even though the "surplus" can evaporate with lower returns. In some cases, ad hoc cost-of-living adjustments or other benefit enhancements are automatically triggered when the plan's funded ration reaches a specified percentage.

What Makes a Pension Obligation Bond Successful?

Of critical importance to a successful pension obligation bond program is that the investment return on proceeds resulting from the sale of bonds must be greater than the cost associated with servicing and settling those bonds. A situation where bonds are issued with an interest cost (Cont. on P. 10)

Understanding Pension Obligation Bonds

(Cont. From P. 9)

of 8% and plan assets are only expected to earn 8%, has very little hope of providing meaningful savings and will likely leave the retirement system in a worse financial position than if the pension obligation bond had not been implemented in the first place. Even in the case where bonds are issued at a 6% interest cost and plan assets earn more than 6% but less than the assumed rate of return, some savings are realized, but this would be mitigated by an increase in plan contributions (due to the actuarial loss on assets). Pension obligation bonds must be issued as taxable bonds. Since taxable bonds have to be issued at higher interest rates than their tax-exempt counterparts, it is more difficult for pension obligation bond offerings to accomplish the desired result.

Using pension obligation bonds to pay off unfunded liabilities in effect substitutes payments to a pension system with payments to bondholders. The difference in interest charges between the pension system's higher assumed rate of return and bond payments can generate savings for the governmental entity. This is analogous to an individual transferring a credit card balance from one card with a high interest rate to another card offering a lower rate. Conceptually, if a plan's assumed interest rate is 8%, bonds are issued at 6% and the proceeds can earn investment return greater than the interest rate on the bonds, then the entity uses the proceeds to offset the unfunded accrued liability and achieves budgetary savings on the 2% difference between the plan's rate and 6%. In addition, it becomes possible to pay down the new debt created by the pension obligation bonds in a shorter time period than was originally planned.

An Example

Consider the following example of how the issuance of a simple pension obligation bond program would create budgetary savings for the issuer. Assume that a local government entity issues bonds for the entire amount of its $100 million unfunded accrued liability and that current contributions to amortize the unfunded accrued liability over 30 years would be $8.2 million per annum. The interest cost on the bonds is 6%, and plan assets are expected to earn 8% per year. The issuer intends to have all bonds settled in 25 years, so in addition to the $6 million interest payments made to bondholders, an additional amount of $1.4 million per year is set aside in a sinking fund, which should appreciate to $100 million when the bonds ultimately mature if the fund earns the expected 8% investment return. Therefore, the planned end result is annual savings of $800,000 for 25 years plus savings of $8.2 million in each of the five following years, since the pension obligation bond debt will be settled before the unfunded accrued liability would have otherwise been amortized. On a present value basis, this equates to theoretical savings of $14 million if all assumptions are realized.

Many practitioners will refer to the implementation of such a pension obligation bond strategy as an *arbitrage play*. However, common definitions of arbitrage often include as parameters the phrases "risk free" and "simultaneous transaction". It should be clearly noted that using pension obligation bonds to effectively create budgetary savings or reduce the overall cost of the pension system is hardly without risk. In addition, there are generally no transactions occurring immediately and simultaneously, as there would be if one were trying to exploit a mispriced security on two stock exchanges. On the contrary, the overall effectiveness of pension obligation bonds won't fully be known until all bonds completely mature. If financial markets return double-digit percentages in the first few years subsequent to issuance of pension obligation bonds, it would appear as if the strategy is going to be successful. However, if in subsequent years, assets under perform relative to assumptions, the result will likely be ultimate failure.

Now consider the earlier example again, but in this scenario assume that plan assets only earn 5% per year instead of 8%. Investment returns that are less than the interest cost of the pension obligation bonds cause an additional strain on cash flows, and that is in addition to the increase in pension funding costs that are already associated with returns that are less than expected. If subpar investment returns continue for several years subsequent to bond issuance, the additional financial strain on the retirement plan would be severe and could put the sponsoring entity into a far deeper hole that it was prior to the pension obligation bond.

Other Considerations

For those entities choosing to pursue pension obligation bonds, there are several additional factors that should be considered. A bond as a fixed income security can come in several flavors, and some may be better suited than others to meeting the objectives of the issuer. A series of zero-coupon general obligation notes in the early years maximizes the amount of principal retired in a faster time frame than if only long-term, coupon-paying bonds are used, while still providing annual budgetary relief. Plan sponsors (Cont. on P. 11)

Understanding Pension Obligation Bonds

(Cont. from P. 10)

should also be aware of how the unfunded accrued liability amortization payments of a pension plan are determined by the actuary. It is fairly common in governmental plans to develop an amortization pattern that increase each year (as a level percentage of payroll) and less common to use a level-dollar amortization approach. See Figure 3 on page 13.

The issuance of, say, $100 million of pension obligation bonds generate a cash infusion of $100 million that must be strategically invested. One consideration would be to invest the entire amount according to the same allocation as instructed in the current investment policy. It may be more advisable to adopt a separate strategy that potentially matches cash flows to pension obligation debt repayment timing. Fund managers may feel pressure to invest the entire amount at once and in securities that are expected to outperform the cost associated with the bond debt. This, however, could be detrimental to the plan if markets are at a depressed state when these purchases occur, since precious amounts of investment return would be sacrificed. The best strategy will be dependent upon the actual circumstances of the issuing entity, but whatever that strategy is, it should be thought of receiving the pension obligation bond proceeds.

While the pension system's funded status may improve after pension obligation bond issuance, thought should be given to the maximum downside risk that can be experienced before the borrowing power of the issuing government is negatively impacted. If the pension obligation bond strategy is structured poorly from the beginning or if the economic environment experiences a downturn, it's possible that the major rating companies will downgrade the credit rating of the sponsoring entity. In this case, the borrowing power of the government for more tradition purposes may be diminished. On the other side of the coin, however, is the increase in good publicity surrounding the improved funded position of the pension plan and the alleviation of concerns from current and prospective retirees and their families. Sometimes the upside of the latter argument can outweigh the downside of the former.

For government entities considering the use of pension obligation bonds, great care should be taken to understand the current state of the pension system, the financial health of the sponsoring entity and the economic outlook for equity and fixed income investments. In the right situation, implementing the proper pension obligation bond strategy could produce budgetary savings in the short and long term, with acceptable downside risk if certain assumptions are not quite realized. Of course, under the wrong set of circumstances, a poorly designed pension obligation bond offering can cause increased costs in any number of ways and drive contribution requirements to intolerable levels.

This article is based on presentation at the 2007 Benefits Conference for Public Employees.

For information on ordering reprints of this article, call (888) 334-3327, option 4.

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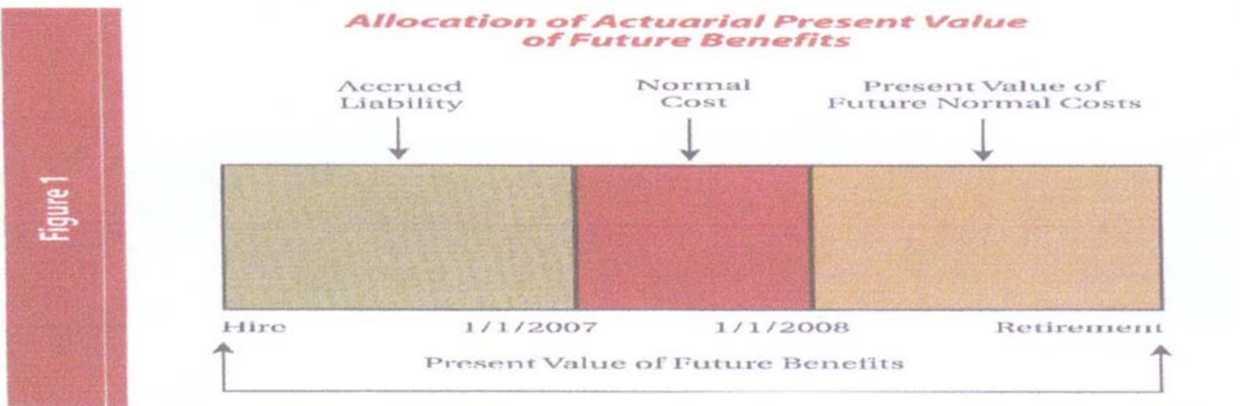
Figure 1
Allocation of Actuarial Present Value of Future Benefits
Accrued Liability
Normal Cost
Present Value of Future Normal Costs
Hire
1/1/2007
1/1/2008
Retirement
Present Value of Future Benefits

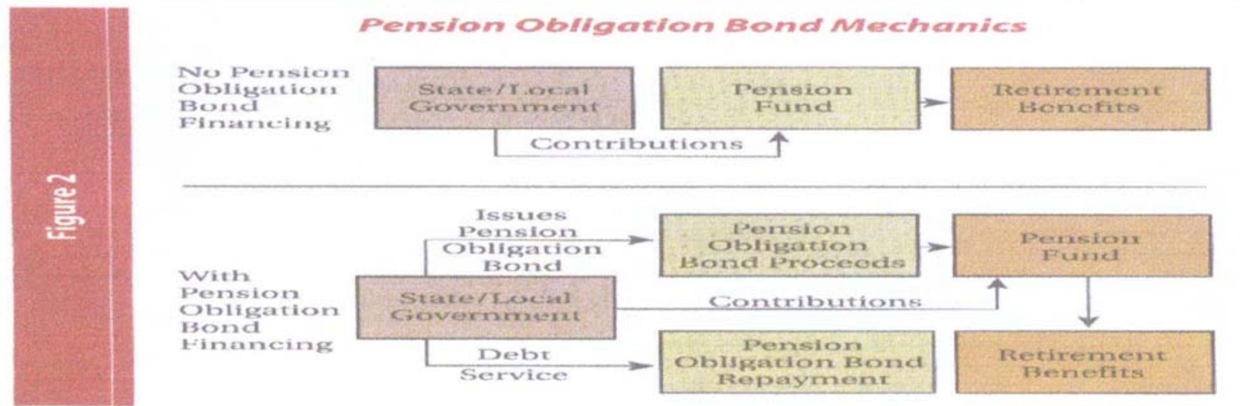
Figure 2
Pension Obligation Bond Mechanics
No Pension Obligation Bond Financing
State/Local Government
Pension Fund
Retirement Benefits
Contributions
Issues Pension Obligation Bond
Pension Obligation Bond Proceeds
Pension Fund
With Pension Obligation Bond Financing
State/Local Government
Contributions
Debt Service
Pension Obligation Bond Repayment
Retirement Benefits

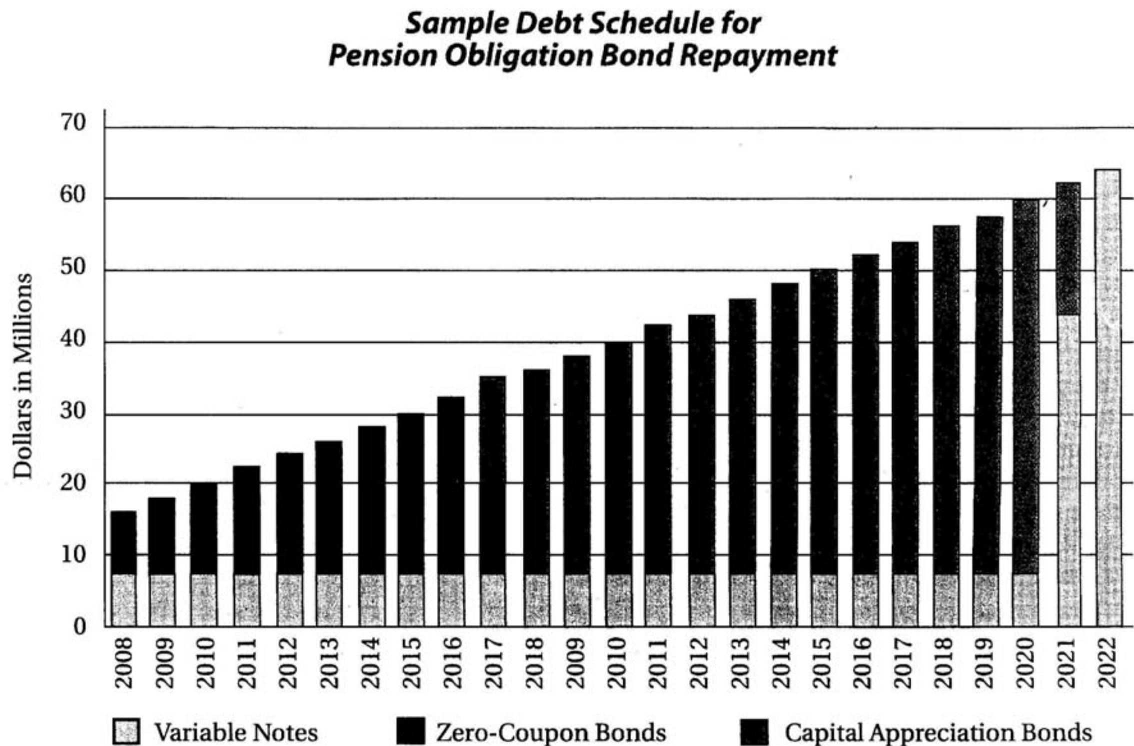
Figure 3
Sample Debt Schedule for Pension Obligation Bond Repayment
Dollars in Millions
0
10
20
30
40
50
60
70
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021
2022
Variable Notes
Zero-Coupon Bonds
Capital Appreciation Bonds

TEACHERS JOIN PUSH FOR REPEAL 0F PENSION REDUCTIONS

This week, teachers across the country are learning more about their Social Security pension benefits, and some Kentucky teachers don't like what they're hearing.

Kentucky Education Association and its national organization, National Education Association, have been rallying members this week to contact U.S. lawmakers and urge them to repeal two amendments to the Social Security Act that reduce benefits for certain public employees.

"What we know is that nine out of 10 of the public employees affected by the GPO (Government Pension Offset) would lose their Social Security spousal benefit," said Frances Steenbergen, president of the Kentucky Education Association. "In addition, for teachers who worked before becoming teachers or during summers, they are likely to lose a significant amount of their Social Security benefits because of the Windfall Elimination Provision (WFP)."

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SOCIAL SECURITY FAIRNESS FOR TEXAS' PUBLIC SERVANTS

Imagine sitting around the kitchen table with your spouse, planning for a well-deserved retirement, only to learn that your monthly Social Security benefits will be hundreds of dollars less than expected. Unfortunately, this nightmare is experienced by many of our state's teachers, police officers, firefighters and other public servants due to a bureaucratic rule that causes Social Security to report erroneous projected benefits and arbitrarily reduce their benefits. To prevent this, I have introduced legislation that protects the retirement savings of our hardest working public servants and ensures that they are not caught off guard by unfair regulations.

Instead of paying into the Social Security system, many state employees and public servants contribute to a non-Social Security plan such as the Teacher Retirement System of Texas or a firefighters' pension fund. When they retire, they receive benefits from these plans rather than from Social Security.

But difficulty can arise for Texans who spend part of their career as public servants not eligible for Social Security, and another part of their career in a Social Security covered job. When the Social Security Administration (SSA) attempts to estimate future benefits for a person with this type of career history, it does not know that they will be receiving pension payments from a public sector retirement plan. As a result, the SSA over-estimates the monthly amount this person is eligible to receive in Social Security benefits, and passes the incorrect estimate on to them to use when planning for their retirement. It is only when these retirees actually apply for benefits that the SSA "corrects" its mistake and reduces the amount of their monthly Social Security check using a rule called the Windfall Elimination Provision (WEP).

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EVIL TWINS RAVAGE SOCIAL SECURITY

Friends of active and retired federal workers, police, teachers and other public employees are hoping legislative lighting finally strikes the evil twins that stalk their Social Security benefits.

The twins collectively eat into or eat up Social Security payments expected by the public workers when they retire.

Congress created the twins decades ago, hoping to prevent retiring civil servants from legally skimming the cream off of Social Security benefits. Lawmakers discovered that several high-paid feds who earned substantial federal pensions also were collecting premium Social Security benefits after completing minimal work.

Studies at the time showed that some high-paid feds "hired" one another to perform menial jobs from mowing lawns to housework at low wages and paying the minimal Social Security tax. After 10 years of service, they qualified for Social Security benefits.

In any case, Congress gave birth to the twins: the windfall elimination provision and the government pension offset.

Windfall elimination can trim hundreds of dollars per month from the Social Security benefit of feds who get pensions for service not covered by Social Security. Those with short service under Social Security take the biggest hit.

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