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Research:

Pension Obligation Bonds Are Surging After Brief Hiatus

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Pension obligation bonds (POBs), the once-arcane debt instrument used to finance unfunded pension liabilities, have returned with a vengeance after a brief hiatus, and are again making their mark on the public finance landscape. A number of conditions have fallen into place to spark this resurgence, including:

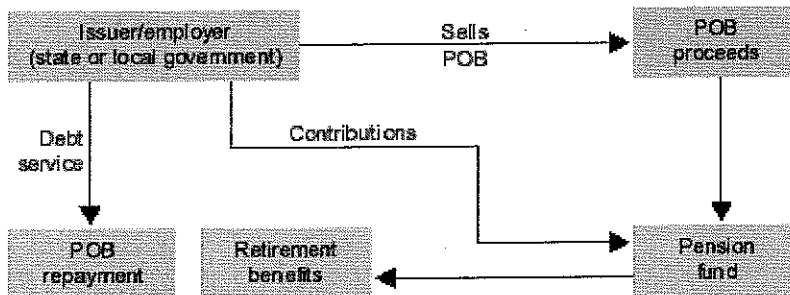
- The rapid growth in unfunded liabilities for public pension funds over the last few years, driven by investment losses, benefit enhancements, and greater longevity of pension plan beneficiaries;
- The relatively low interest-rate environment, which widens the spreads between the POB interest costs paid by the issuer/employer and the assumed investment return rate of the pension systems, which makes the economics of the transaction more attractive; and
- The potential cost savings from a POB, as many state and local employers struggle with budgetary imbalances and other savings alternatives become scarce.

Because of the confluence of these factors, POBs are back. This report details the mechanics of how POBs work, their history, the special risks unique to this debt instrument, the critical rating factors and implications, and future prospects.

■ How POBs Work

While the financial implications of POBs are complex, the actual mechanics are relatively simple. Generally, the municipal employer will use the findings from the most recent actuarial valuation, or have a new valuation completed, to determine the pension system's unfunded actuarial accrued liability (UAAL). Then, it will decide what portion of the UAAL (either all or a part) will be funded with the POB. In the 1990s most employers funded the entire UAAL, but for various reasons discussed below, many now tend to finance less than the full amount. Once the POB is sized and sold, the net proceeds are placed in the pension trust fund to be commingled with the other funds, and usually invested according to the existing asset allocation guidelines (see Chart). Thus, the pension fund experiences a rapid increase in assets resulting in a higher funded ratio (actuarial value of assets divided by actuarial accrued liability). For the POB to generate savings for the employer, the investment return rate on the POB proceeds must be greater than the interest cost of the bonds (and ideally equal to, or exceed the pension system's investment return assumption), and the larger the spread between these two rates the better. The employer, as POB issuer and obligor, would then be projected to achieve lower total pension contribution and debt service costs than it would have if it had not sold the POB.

Pension Obligation Bond Mechanics



■ Brief History

While there were a few issues in the 1980s, the first big wave of POBs really came in the early 1990s. By the end of the decade about \$15 billion of POBs had been issued. The years 2000 and 2001 were slow from a POB standpoint, with 2000 correlating to the apex of U.S. public pension funding at an average funded ratios of slightly over 100%, up from only about 80% in 1990. These robust funding gains were fueled by above-average equity returns during the period and a general shift in the weighting of public pension assets to this asset class from fixed-income. The corollary to a high funding level is a lower or nonexistent UAAL. Falling funding ratios, now estimated to be heading towards the 90%, have been exacerbated by a combination of adverse circumstances, some uncontrollable and some self-inflicted. These factors include the decrease in asset values from poor equity returns and the increase in liabilities from benefit enhancements and demographic changes (for example, members living longer). The second wave of POBs, driven by burgeoning unfunded liabilities, has come on strong in 2002 and 2003. As in the first wave, California counties have been leading the pack, and there are a number of repeat borrowers, but there are also significant new players. The state of Illinois, which issued in June of this year, now holds the POB record for sheer size at \$10 billion — almost four times larger than the previous record. Oregon sold a \$2 billion issue last fall, and other states that have recently completed or plan a POB sale include Kansas, Wisconsin, and West Virginia.

■ POB Risks

The principal risks to the issuer of a POB fall into a number of categories:

- Arbitrage (investment return/POB interest cost);
- Leverage;
- Market risk; and
- Political.

POBs are essentially an arbitrage play, the success of which is dependent on the premise that the pension fund assets (including POB proceeds) will earn on average more than the interest cost on the POBs and hopefully the assumed investment return rate (generally about 8%) or better each year for the life of the bonds. If the bonds are sold at an interest cost of 6%, for example, the spread could generate handsome savings if the investment returns goals are met over the life of the bonds. The problem is that there is no certainty that the average 8% return will be realized over time, and therein lies the principal risk of the POB to the issuer. If the pension fund earns 8% or more on the POB proceeds, then the result will be success by virtue of having to pay lower pension-related costs (contributions plus POB interest) than without the POB. However, if the investment return is less than the POB interest cost, the transaction becomes a drag on cash flows. Not only will the employer have the new POB debt service costs but also higher contribution rates attributable to new unfunded liabilities from under performing investment returns. If returns are above 6% (as in the example above) but below 8%, the employer will have increasing contribution rate costs, but it would have had them even without the POB. When investment returns are less than the POB interest costs, the POB puts additional strains on financial operations rather than helping.

While the 1990s produced some impressive investment returns, no pension fund consistently earns 8% or higher every year in perpetuity; returns vary dramatically and may (or may not) average the investment return assumption or even the POB interest rate cost. The POB paradigm has a goal to average or beat the 8% investment return assumption over the long-term. With the appropriate asset allocation strategy this goal may be attainable, but market experience over the last several years has led some to believe that an 8% return assumption may be too aggressive.

Another factor in evaluating the success of a POB is that its full effect can only fully be tallied at final maturity of the bonds. Due to market gyrations, a POB may look like a great success for several years, or even a decade, only to see investment gains erode, and at maturity are pronounced a failure. Conversely the exact opposite may be true, with poor results in the early years later overcome to achieve projected benefits in the final analysis.

In any event, we do know that even if projections are met on average over the life of the POBs, there will be years with returns that are higher, and some that are lower (maybe significantly), than the 8%

bogey. We do not have to look back very far to see evidence of such swings: in fiscal 2001 the S&P500 index of domestic equities fell 16%, in 2002 it fell another 19%, but in 2003 it fell only 1.6%. These market declines hurt issuers with POBs outstanding: most had to pay increased contribution rates to cover the new actuarial losses, plus they had the higher debt service costs due to the POB.

The risk of adding too much leverage is another factor for POB issuers to consider. Borrowing for any purpose increases leverage, and incurring debt to pay unfunded liabilities is no different. While the issuer is substituting one type of long-term liability (POB) for another (UAAL), there is a difference. In most cases, bond debt service is a "harder" obligation than the "softer" contribution payments used to amortize the UAAL. Bond debt service must be paid in full and on time or the issue falls into default, with wide ramifications. For certain employers, contribution payments, on the other hand, may be temporarily deferred or reduced without serious negative consequences. Therefore, the size of the POB relative to the total debt structure of the issuer must be measured in terms of what level of debt service can be managed if actual future investment returns do not meet the original POB plan projections.

Because POBs generate very large infusions of funds into the pension system compared with the more steady investment and reinvestment of interest, dividends, and contributions by the fund, the plan for investing POB proceeds must be considered. Should the monies be invested according to the existing asset allocation guidelines, or should POB proceeds have a special allocation strategy because of current market conditions or expectations? If the chief investment officer of the fund believes that international equities, for example, are overvalued, maybe a delay in filling that allocation would be warranted. On the other hand, in that pension funds are long-term investors, most have stuck with their traditional allocations for proceeds, eschewing market timing strategies. Whatever the strategy may be, it should be fully vetted before the POB sale.

Another aspect that few envisioned when this instrument was first initiated is the political risk hidden, almost like a Trojan horse, within the POB structure. As was mentioned in a feature on this subject, ("Pension Obligation Bonds: Unique Rating Documentation", RatingsDirect, March, 4, 1999), POBs can become victims of their own success. For example, if a POB is issued for the full UAAL, resulting in a 100% funded ratio, and subsequent higher-than-average returns push the ratio to 110% or 120%, there will arise tremendous political pressure to distribute the so-called "excess" funding by increasing benefits, thus incurring new liabilities. The excess funding touted in the late 1990s turned out to be illusory. Even systems bolstered by POBs that did not increase benefits found themselves in under funded positions following the market declines from 2000 to 2003. Those that fell victim to the siren's song and increased benefits have even lower funding levels. Some pension funding ratios declined to the extent that the employers' opted to go back to the market to issue POBs for a second time.

■ Analysis

The rating process for POBs basically parallels that of long-term debt with similar security plus with certain additional analytical factors pertinent to the POB and pension system. Most POBs issued to date have a GO or general fund pledge. Also, a high percentage of those sold have been additionally secured by bond insurance. In Standard & Poor's analysis specific to POBs we focus on the effect of the bonds on the issuer's debt structure and its ability to meet its obligations. The financial review includes the impact on both the balance sheet and the operating statement or cash flows. The status of the issuer's pension fund on a pro forma basis is also part of the review as with any similar analysis.

From the balance sheet perspective, we look at how the POB fits into the issuer's total debt plan. Does the POB dramatically alter the issuer's debt profile? We look at total debt with and without the POB so as not to penalize a POB issuer in comparison to another issuer that might have relatively low debt (and no POBs) but sizable unfunded pension liabilities. Also, we evaluate the leverage added by the POB. Does it markedly increase hard, fixed costs (bond debt service) in place of a softer, more discretionary obligation (pension contributions)? If sub par investment returns put upward pressure on contribution rates will they, coupled with the new higher debt service costs due to the POB, put the issuer's budget under greater strain? The issuer must also be cognizant of the effect the POB issuance may have on statutory debt limits. Will the POB use up debt capacity that might be needed for other, more pressing needs?

From a cash flow standpoint, Standard & Poor's reviews projected debt service and contribution costs, with and without the POB, including the validity of the assumptions including those for POB interest

costs and pension fund investment returns. How do the projections compare in total and on an annual basis? The spread between interest costs and investment return generates the savings expected from the transaction. What is the magnitude of annual savings and total present value savings? Where (in what years) are the savings taken? Are the savings front-loaded in an attempt to mask budgetary stress? Will any front-loading lead to higher, unsustainable contribution rates in later years? Do the potential savings from the POB outweigh the risks involved? The analysis of the cash flows is a critical component to understanding the full impact of the transaction.

As part of the POB analysis we also review the current status of the recipient of bond proceeds — the pension system itself. What is the statutory relationship between the issuer/employer and fund? How have the laws and precedents for making contributions affected funding progress and how do they play into the POB strategy? Have funding levels generally been increasing over time? What are the funding goals and how will the POB impact these objectives?

The pension fund's general actuarial methods and assumptions also will be reviewed for comparative purposes. The fund's asset allocation strategy will be studied for consistency with the POB assumptions and for the general risk profile. An aggressive investment strategy may make the POB objectives more difficult to achieve on a consistent basis.

■ Rating Implications

Employers looking to help manage their unfunded liabilities through the issuance of a POB should weigh the pros and cons very carefully. Any applicable risks from the above list should be evaluated. There should be a clear POB plan with attainable actuarial and investment assumptions and a conservative structure. Prudent allocation for projected savings over time limits the chances for problems

It is possible for POBs to have a negative effect on credit quality, especially in the investment environment over the last several years or if they were structured poorly at the outset. Standard & Poor's will continue to evaluate POB risks in light of each employer's individual profile at the time of sale as well as their projected effects over time. POBs may work as planned over the long-term, but short-term fiscal dislocations resulting from these structures are part of their baggage.

■ Special Rating Documentation Requirements for POBs

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

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



PERISCOPE

Public Employee Retirement Systems

Public plan DB/DC choices

Mark Olleman, FSA, MAAA

This article is about choices: When given the choice, do public employees choose a defined benefit (DB) plan or a defined contribution (DC) plan? Do employers give employees the chance to choose a second time? What happens when employees choose their own investments? Can employers choose to offer meaningful death and disability benefits to DC members? What are the implications of an employer choosing to change from a DB to a DC plan? This article looks at the recent experience of statewide retirement systems to provide some answers.

What do public employees choose?

Many people claim that DC plans are more attractive to new employees than DB plans. Is this true? As a test, note that in the last 10 years, the seven statewide systems listed in Table 1 have begun giving new hires the choice between participating in a DB or a DC plan. Their experience indicates that public employees prefer DB plans. The percentage of new employees electing DC plans ranges from 3% in the Ohio Public Employee Retirement System to 26% in Florida.

Table 1 shows that many of the members going into a DB plan never submit an election and are placed in the DB plan by default. However, based on survey data, Florida found that "up to 45% of the defaulters may be using this option as their active election in the belief that by defaulting there could be no mistakes made in their plan choice." What is more, Table 2 shows that in Washington PERS—the only system where DB is not the default—63% of new members have actively chosen an all-DB plan (Plan 2) over the default of a combined DB and DC plan (Plan 3).

Most of these DB/DC choice plans have had relatively stable election percentages in the short time they have existed. However, we do not know how the choices members make will change in the future. The stock market decline of 2000 to 2002 has certainly influenced many members. No doubt factors such as the future of the stock market and the experiences of people retiring with only DC plans will influence future member choices. The financial market experience of late 2008 may have some influence as well.

TABLE 1

NEW HIRE ELECTIONS IN MOST RECENT COMPLETE YEAR

SYSTEM	DB BY DEFAULT	DB ACTIVE ENROLLMENTS	DC ACTIVE ENROLLMENTS	COMBINED PLAN ACTIVE ENROLLMENTS
COLORADO	39%	43%	18%	NOT OFFERED*
FLORIDA	55%	19%	26%	NOT OFFERED*
MONTANA PERS	90%	NOT SEPARATED*	10%	NOT OFFERED*
NORTH DAKOTA**	88%	NOT SEPARATED*	12%	NOT OFFERED*
OHIO PERS	82%	13%	3%	2%
OHIO TEACHERS	72%	14%	11%	4%
SOUTH CAROLINA	80%	NOT SEPARATED*	20%	NOT OFFERED*

* "NOT SEPARATED" MEANS ACTIVE DB ENROLLMENTS HAVE NOT BEEN SEPARATED FROM DEFAULT DB ENROLLMENTS.

"NOT OFFERED" MEANS THERE IS NOT AN OPTION TO ENROLL IN A COMBINED DB/DC PLAN.

** NORTH DAKOTA STATISTICS ARE FOR JANUARY 2001 THROUGH JUNE 2008.

TABLE 2

**CUMULATIVE WASHINGTON PERS NEW HIRE ELECTIONS
FROM MARCH 2002 TO SEPTEMBER 2008**

PLAN 3 COMBINED DB & DC BY DEFAULT	PLAN 3 COMBINED DB & DC ACTIVE ENROLLMENTS	PLAN 2 ALL DB ACTIVE ENROLLMENTS
19%	18%	63%

Tables 1 and 2 summarize the experience of systems that allow their members to choose between a DB plan and a DC plan. Ohio and Washington state members also have the choice of a "combined" plan, where employer contributions fund a DB plan and employee contributions fund a DC plan. Washington state members do not have the option of an all-DC plan.

What about do-overs?

One plan design choice employers face is whether to give employees a chance to change their mind. This chance for a do-over has been referred to by some as the pension mulligan. Although Montana PERS, North Dakota, Vermont, and Washington state require new hires to make a one-time irrevocable decision, other systems do not. Colorado allows members to change their election one time in years two through five after hire. Ohio Teachers and South Carolina also allow members to change their election once in the first five years, but only from DC to DB. Florida allows members to change once at any time before retirement or termination of employment. Last, Ohio PERS allows members to change up to three times: once in their first five years of employment, once in their second five years, and once more at any time after 10 years of service through retirement.

You might ask, "What do systems do when members change their mind?" Florida allows two choices when members switch from the DB to the DC plan. The members can either (1) freeze their current DB benefits based on service and salary to date and have future contributions accumulate in their DC accounts, or (2) convert their DB benefits into DC accounts based on the value of the normal retirement benefit.

If a Florida member wants to switch from DC to DB, the member must pay the full cost based on either the present value or the actuarial accrued value, depending upon where the member has previous DB service prior to joining the DC plan. The DC account is used first. If there is more money than needed in the DC account, the member keeps the extra in the DC account. If there is not enough money in the DC account, then the member must pay the difference or stay in the DC plan.

Ohio PERS, which allows up to three changes, takes a somewhat different approach. Changes are prospective only, but members transferring to the DB or combined plan have the option to purchase service in the new plan using their DC accounts. Frozen DB benefits are based on salary and service during DB membership only.

The do-over could be particularly valuable when a member's situation changes. As an example, the portability of a DC plan might be attractive to a teacher who does not expect to stay long in a position due to a military spouse who is frequently moved around the country. However, if the couple's plans change and they decide to settle down, the teacher might want to change to the DB plan.

Can meaningful death and disability benefits be provided in a DC environment?

Yes, meaningful death and disability benefits can be provided in a DC environment, but it will require supplemental contributions. Consider the choices three states have made to respond to the criticism that DC accounts do not provide adequate death and disability benefits.

In Florida, where members choose between a DB and a DC plan, disabled members can choose to surrender their DC account balance and receive the same disability benefits as provided by the DB plan. This raises a question: Where does the money to finance this benefit come from? The answer is that the employer pays a separate charge ranging from 0.25% of pay for general members to 1.33% of pay for special risk members, and a side account is maintained to finance the difference between the cost of the disability benefits and the dollar amount of the DC accounts surrendered by the members. If DC members die in Florida, their death benefit is the DC account balance. Montana PERS has a similar provision where 0.30% of DC member pay is set aside to finance long-term disability benefits.

Alaska has a different approach. Alaska public employees hired after July 1, 2006, all go into a DC plan. Here the occupational death and disability benefit is 40% of salary until normal retirement (50% of salary for the occupational death of police and fire members). The employer continues both the employer and employee contributions into a special occupational death and disability trust account until the member reaches normal retirement, or until the date the member would have reached normal retirement in the case of occupational deaths. At normal retirement age, the 40% (or 50%) of salary benefit stops, and the member, or survivor, receives the DC account as well as the accumulated contributions from the occupational death and disability trust account with actual returns net of expenses. Employers make contributions into a separate fund to finance the extra benefit not provided by the DC account.

What happens when employees choose their own investments?

Experience indicates the average employee directing his or her own investments earns lower investment returns than a statewide DB system. Here is the experience of two states.

Nebraska's state and county employees hired between 1964 and 2003 had only a DC plan. During the same period, Nebraska maintained separate DB plans for its school employees, state judges, and state patrol. Over the 20 years leading up to 2002, the average return in the DB plans was 11% and the average return in the DC plans was between 6% and 7%. Why the significant difference? One reason is that nearly 50% of DC member contributions were invested in the stable value fund. The stable value fund was the default for members not making a specific investment election. Although the stable value fund is very conservative and the investor's balance will not decrease, the investor also has a lower expected rate of return. Partially due to the lower returns, employees were receiving a replacement ratio of their pre-retirement income closer to 30% rather than the projected 50% to 60%. Nebraska has since decided that employees hired on or after Jan. 1, 2003, will go into a hybrid defined benefit plan.

West Virginia had a similar experience. Teachers hired between 1991 and 2005 had only a DC plan. Teachers hired after July 1, 2005, go into a DB plan instead. One of the reasons for this change is that average DC returns lagged DB returns. As an example, during the seven years from 2001 to 2007, the DB plan outperformed the DC plan in both the best and worst markets. The DC return was higher in only one of the seven years. Over the seven year period, the average DB return was 3.15% higher. Specific returns are shown in the appendix.

Do DC members have to choose their own investments?

Employees directing their own investments tend to earn lower investment returns than statewide DB systems for a variety of reasons. DC members are part-time investors, whereas DB plans are managed by full-time highly trained professionals. DB plans have investment options that are generally not available to DC members, such as real estate, private equity, and hedge funds. DC members often lack discipline and chase returns. Does this mean that DC members cannot earn the same investment returns as DB plans? No, DC members can earn exactly the same returns. Members of Washington state Plan 3 have the option to invest in the Total Allocation Portfolio (TAP), which mirrors the investments in the state DB plan and therefore earns the same returns. Washington has made the TAP the default investment option for Plan 3, and approximately 61% of the members' DC assets are in the TAP option.

The employee contributions of members in the Oregon Public Service Retirement Plan go into the Individual Account Program (IAP). Like Washington's TAP, Oregon's IAP money is invested in the

same manner as the DB plan. However, unlike Washington's TAP, which is one of many investment choices, in Oregon's IAP there are no other investment choices, and so all DC money is invested to match the DB plan.

Both Washington and Oregon provide members with a professionally managed portfolio. Washington's approach leaves room for individual risk tolerance. For instance, members near retirement may not want to take as much risk. Oregon's approach ensures that all member funds are invested in a carefully managed portfolio. Either way, it is ironic that DC members may need to give up their ability to choose their own investments in order to earn returns competitive with DB plans.

Both the Washington and Oregon plans are hybrid plans where employer contributions fund a DB plan and employee contributions go into a DC plan. This is significant because the DB plan will provide some level of guaranteed income regardless of DC investment returns.

Does changing to DC solve funding problems?

In 1991, the West Virginia teachers' poorly funded DB plan was closed to new members. All new hires were put into a DC plan. This funding solution overlooked some important considerations:

- New members do not start with any unfunded obligation.
- Projected contributions for new members were worth more than the projected DB costs for those members.
- No unfunded obligations for existing members are reduced when new members go into a DC plan.

As a result, the loss of new members made it more difficult to finance the unfunded obligations of the West Virginia Teachers' Retirement System (TRS).

In 2003, West Virginia studied whether teacher retirement should be returned to a DB plan. Another factor in the decision was that 4,500 members who transferred from the DB to the DC plan in 1991 found it hard to retire after the bear market of 2000-2002. When also considering the lower average returns that were earned on the DC member accounts, the state decided that starting in 2005 all new hires would go into the DB plan to save money. After studying the issue, the state decided that funding a DB plan properly would be less expensive than a DC plan providing equivalent benefits. The state has shown discipline to achieve this proper funding, with extra contributions of \$290.1 million in fiscal year 2006 and \$313.8 million in fiscal year 2007. In addition, West Virginia completed a tobacco bond securitization in fiscal year 2007 and deposited \$807.5 million of those proceeds into TRS as another special appropriation. Most recently, in June of 2008, the teachers in the DC plan were given the choice to switch to the DB plan. Seventy-eight percent chose to switch.

West Virginia projected a \$1.2 billion savings in the first 30 years due to moving new entrants from the DC to the DB plan. This relies on an assumed return of 7.5%. The Legislature asked what return would be needed to break even. The answer was 6.0%. In order for the DB plan to save money, a projected return of more than 6.0% was needed. The employer cannot avoid funding risk with a DB plan, but changing to a DC plan does nothing to take care of unfunded obligations.

Some states require specific contributions to the DB plan as a percent of DC member pay in order to finance preexisting unfunded liabilities and to defray expenses. The systems include Colorado, Montana PERS, Ohio PERS, Ohio Teachers, and South Carolina. Details are in the appendix.

What are the implications of these choices?

The choices discussed in this article have many implications. Public employees have overwhelmingly chosen DB plans over DC plans. This implies that DB plans are more attractive than DC plans to public employees. This is not surprising, as public employees tend to have long service. Some systems have chosen to allow their members a second choice. This do-over could help an employee reverse a bad decision. Some systems have chosen to provide meaningful death and disability benefits in a DC environment; however, supplemental contributions are required. Employees tend to earn less when they choose their own investments. However, this can be countered in a DC plan by using an alternative like Washington state's TAP or Oregon's IAP, where the DC assets are invested in the same manner as the DB assets. Choosing to change from a DB to a DC plan does not solve funding problems.

In the final analysis, it's a question of accumulation and distribution. The accumulation of contributions and investment earnings determines available retirement income. A plan that maximizes investment earnings maximizes the benefits provided by contributions. Public employees are choosing plans that provide lifetime distributions. There is not yet much experience on how many DC members have been able to make their assets last a lifetime. The distribution phase and the loss of longevity risk pooling in retirement is probably the hardest obstacle for DC plans to overcome. The consequences of outliving one's assets are severe. DC plans rarely measure whether assets accumulated will provide adequate retirement income. How many employees can be sufficiently educated and empowered to navigate the risks of pre-retirement accumulation and postretirement distribution?

There often seems to be a choice between the employer bearing all the risk of funding a defined benefit and the member bearing all the risk of accumulating sufficient assets to last a lifetime. However, there are some choices that share risk between employers and employees, such as the combined DB/DC plans in Washington, Oregon, and Ohio, and DB plans where contribution increases are shared by employees. More choices are needed where risk is shared, or better yet reduced, and adequate retirement benefits are provided for a reasonable cost.

Further details are provided in the appendix available on Milliman's Web site.

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Mr. Sullivan asked Mr. Crane's opinion of pension obligation bonds (POB).

Mr. Crane replied that it could be a good alternative, but the downside of such bonds, versus funding without a bond, is that POBs do indeed increase a state's real debt load by the full amount of the issue, whereas the unfunded liability with a POB is really a "soft" debt of retirement plan obligations. He went on to say that retirement plans have more latitude in the public sector to stretch out payments as well as the ability to make more assumptions regarding future investment returns. Accordingly, funding the plan directly, as opposed to a POB issue, allows the state more flexibility in managing its fiscal affairs from year to year.

Mr. Morganelli asked of certain concerns relating to public safety worker classifications (e.g., police and firemen) and what kind of plans could be implemented to address those concerns.

Mr. Crane replied that a contribution rate could be constructed to get funding to the position it should be and managing risk of investment is a great consideration. "Target date investment" strategies coupled with annuities should be considered to guarantee a good portion of the benefit. He added that another major reason the use of a full-defined contribution plan is questioned for public safety workers is because of pension disability benefits. He stated that, because of the nature of their job risks, it is difficult to get insurance companies to issue disability insurance policies for police and firefighters and that there are a lot of efficiencies existing in a defined benefit plan for public safety to address these issues.

Mr. Morganelli asked if the contribution rate would be so high for such employees that it would be unlikely to reach the retirement benefit in a defined benefit plan if the disability issue were addressed with a separate insurance policy.

Mr. Crane answered that if a person works a full career, it is possible to obtain the right amount of funding, but if a person begins a career later in life, it is much harder to deliver that benefit on a cost effective basis.

Judge Bucci asked why the Nebraska defined contribution plan was closed in January of 2003?

Mr. Crane replied the market had a downturn after 9/11/2001 and many participants' investments were hit hard. Legislators converted the plan to a cash balance system, which they felt better-suited public employees going forward. Many participants ended up being over or under invested in equities over the years. He added that a cash balance system guarantees a four or five percent fixed rate of return.

Chairman Williamson then turned his attention to upcoming agendas for the Commission. He stated that in the weeks to come, the Commission will have presentations relating to legal components, specifically the propriety and property right argument, the issue of vested vs. non-vested employee—to make a determination whether the Commission will look at changes to vested employees, not yet vested employees and new hires.