Town of West Hartford

Pension Obligation Bonds FAQ's

Q. What is a Pension Obligation Bond?

A Pension Obligation Bond (POB) is an instrument of indebtedness issued by a municipal or State entity to fund all or a portion of the Unfunded Actuarially Accrued Liability (UAAL) for its pension plan.

Q. What is the purpose of a Pension Obligation Bond?

POB's are intended to take advantage of potential arbitrage opportunities. The bond proceeds, when invested as part of pension assets in higher yielding asset classes, should achieve a long-term rate of return that is greater than the interest rate owed over the term of the bonds.

Example: Expected Long-Term Asset Growth:	***6.25%***
Bond True Interest Cost:	***3.00%***
Variance (Arbitrage):	***3.25%***

Q. What component of the overall pension liability will be impacted?

The significant portion of the pension cost is funding the Unfunded Accrued Liability, or the cost associated with benefits that were earned in the past but are not currently matched with plan assets. Pension Obligation Bonds (POB's) are issued only to address this lability.

Q. Why is the Town Administration proposing this?

- ***The unfunded accrued liability in the pension trust is currently $315M and the plan's funded ratio is 40.6%. The Town has been very diligent over the past ten years with respect to taking all necessary and thoughtful action to increase the funded ratio, such as the gradual reduction of the discount rate, the use of updated mortality tables and changes in the benefit structure. Despite all the changes and actions mentioned, the Town has been unable to increase the funded level to an appreciable degree. The steady increase in the Town's annual actuarially determined employer contribution (ADEC) payment has exacerbated this concern.***
- ***Given the unfunded liability, the ADEC is one of the Town's most significant cost drivers. The issuance of POBs would allow us to fund our pension obligation at a lower annual cost, resulting in tax relief and a fully funded pension plan. Our asset growth rate, based on a conservative 6.25% assumption, should yield net present value savings of $140.9M over a 30-year period.***
- ***The Town has a unique opportunity to take advantage of historically low interest rates.***

- ***West Hartford is financially sound, with an AAA bond rating from both Moody's and Standard & Poor's; the Town's analysis is based on realistic asset growth assumptions.***
- ***The pension bond reserve fund would provide an additional fiscal buffer to mitigate significant increases in the remaining ADEC payments.***
- ***Our actuary has completed testing of a stochastic model that indicates that we would deplete the reserve fund in less than 3% of 10,000 possible outcomes. This represents a 97% probability that reserve funds would be available to mitigate any significant increases in pension contributions over the bond repayment period.***

Q. Why Pension Bonds do not work for some communities.

- ***Issued by distressed communities with pension cash flow issues and limited financial flexibility***
- ***Issued when market conditions are not necessarily favorable***
- ***Issued with aggressive asset growth assumptions***
- ***Issued with no back-up plan to mitigate potential increases in pension contributions during times of economic downturn***
- ***Historically issued without any stochastic analysis***

Q. What makes West Hartford Different?

- ***West Hartford is a financially sound AAA rated community by both Moody's and Standard & Poor's***
- ***This is a unique opportunity to take advantage of historically low interest rates***
- ***The analysis performed is based on realistic asset growth assumptions***
- ***A Pension Bond Reserve Fund will be created to mitigate potential contribution increases during times of economic downturn***
- ***West Hartford has commissioned a rigorous stochastic analysis of 10,000 scenarios to ensure we are considering the full range of possible risks over the lifetime of the pension bonds***

Q. What are the details of the proposed arrangement?

- ***The amount of debt issued (approximately $365M) will bring the plan to 100% funded as of July 1, 2021, based on an interest rate assumption of 6.25%***
- ***The POB proceeds will be deposited immediately into the pension trust in low risk investments and gradually invested in higher asset classes over a period of time***
- ***The contribution the Town is budgeting for FY 2021-22 ($26.9M) will be deposited into a reserve fund, which will be invested in low-yielding cash-like investments***
- ***The reserve fund will be used to shield the Town from contribution volatility by picking up any year-over-year increases in the Actuarially Determined Contribution (ADEC) of more than 5%***
    - → ***ADEC increases by 4% means the Town's budgeted contribution increases by 4%***

- → *ADEC increases by 6% means the Town's budgeted contribution increases by 5% and the reserve fund contributes the remaining increase*
- ***The reserve fund may be used to pay debt service on any outstanding pension bonds only if an analysis is performed by the Town's Consulting Actuary that indicates there is less than a five percent chance that the funded ratio will be less than 100% at any time during the term of the pension bonds.***

Q. How does a Pension Obligation Bond affect the risks faced by the Pension Plan?

- ***The plan currently has a significant Unfunded Accrued Liability***
- ***Much of the Town's annual contribution to the pension plan is devoted to fully funding this over a long period of time***
- ***This is a "soft" debt: there is no requirement to fully fund the pension plan***
- ***A POB is a "hard" debt: the Town must pay the debt service and is required to pay the annual Actuarially Determined Employer Contribution (ADEC)***
- ***The POB adds hundreds of millions of dollars to the pension plan's assets in order to make it fully funded as of July 1, 2021***
- ***In theory, borrowing at 3% and investing the proceeds at 6.25% should save the Town money over the long term***
- ***Adverse market performance (relative to the 6.25% assumption); will trigger use of the pension bond reserve fund. Given the annual fluctuation of investment gains and losses, the plan may become over and underfunded during various years over the life of the bonds. Any plan gains and losses will be amortized over the next twenty-five years.***
- ***In order to analyze the trade-off between cost savings and increased investment risk, the Town's Consulting Actuary constructed 10,000 scenarios of possible investment performance over the next 25 years***
- ***For each scenario, the pension plan's financial picture and the Town's contribution level over the 25 year period was analyzed***
- ***The scenarios were sorted by outcome and displayed graphically so the most favorable outcomes, the least favorable outcomes, and the middle-of-the-road outcomes could be identified***
- ***The same stochastic analysis process was used to analyze how each of the elements of the POB package would impact the likely outcome:***
  - ✓ ***Amount of POB to issue (not to exceed $365M)***
  - ✓ ***Length of bond term (25 years)***
  - ✓ ***Interest rate on bond (estimated at 3%)***
  - ✓ ***Amount to deposit into the reserve fund ($26.9M)***
  - ✓ ***How the reserve fund is invested (short-term cash equivalents)***
  - ✓ ***Trigger for accessing the reserve fund to control ADEC volatility (5% of year-over-year ADEC increase)***
  - ✓ ***Continuing to pay the Normal Cost when the plan is modestly overfunded***
  - ✓ ***Projected total Net Present Value savings based on previously stated bond rates and investment gain assumptions: $140.9M***

Revised: 01/22/2021