Texas Public Policy Foundation

March 25, 2019

Testimony before the Senate Committee on State Affairs: SB 957

Madame Chair and Members of the Committee—

My name is James Quintero and I represent the Texas Public Policy Foundation, a free-market research institute based in Austin, Texas. Thank you for taking the time today to discuss Senate Bill 957, a bill to require municipalities to seek voter approval of pension obligation bonds issued in an amount that exceeds $50 million. I am here to testify in support of the bill.

Pension obligation bonds (POBs) are a type of financial instrument used by some state and local governments to fund part or all of a plan's unfunded liability through borrowing. Proceeds from the issuance of the bond are invested, through the pension fund, with the intent of realizing higher investment returns than otherwise possible using only contributions. As one might imagine, there is a certain degree of risk associated with using these instruments.

In a January 2015 article, the Government Finance Officers Association cautioned the following of POBs:

- The invested POB proceeds might fail to earn more than the interest rate owed over the term of the bonds, leading to increased overall liabilities for the governmental entity;
- POBs are complex instruments that carry considerable risk. POB structures may incorporate the use of guaranteed investment contracts, swaps, or derivatives, which must be intensively scrutinized as these embedded products can introduce counterparty risk, credit risk, and interest rate risk;
- Issuing taxable debt to fund the pension liability increased the jurisdiction's bonded debt burden and potentially uses up debt capacity that could be used for other purposes. In addition, taxable debt is typically issued without call options or with "make-whole" calls, which can make it more difficult and costly to refund or restructure than traditional tax-exempt debt;
- POBs are frequently structured in a manner that defers the principal payments or extends repayment over a period longer than the actual amortization period thereby increasing the sponsor's overall costs; and
- Rating agencies may not view the proposed issuance of POBs as credit positive, particularly if the issuance is not part of a more comprehensive plan to address pension funding shortfalls.

Similar concerns were expressed by Moody's Investor Services who, in a December 2012 article, asserted that: "…pension bonds are often a red flag associated with greater rigidity of long term obligations, failure to find sustainable solutions to pension funding and a pattern of pushing costs off into the future. For this reason, most pension bonds have, at best, a neutral impact on our overall assessment of an issuers credit quality."

In Texas, concerns about POBs are even more pointed because they can be issued without voter approval.

Currently, POBs are the only type of general obligation bond allowed to be issued without an election, meaning that governments can expose the public to tremendous financial risk without allowing them a voice in the process first.

Since these instruments were created in the early 2000s, Texas' local governments have accumulated a substantial amount of POB debt. In 2017, a Pension Review Board report suggested that POB debt had grown to more than $1.2 billion.

2017 Guide to Public Retirement Systems in Texas

Texas Pension Review Board

PENSION OBLIGATION BONDS ISSUED AND OUTSTANDING AS OF 8/31/2016

Govt Name	Issue Name	Closing Date	Maturity Date	Par Amount Issued	Principal Outstanding as of 8/31/2016	Percent Outstanding	Scheduled Interest as of 8/31/2016	True Interest Cost
Dallas	Txbl GO Pension Bonds Ser 2005A	02/16/2005	02/15/2035	$186,575,000	$118,845,000	64%	$54,849,150	4.98%
Dallas	Txbl GO Pension Bonds Ser 2005B	02/16/2005	02/15/2035	$137,772,609	$70,860,086	51%	$532,574,914	5.32%
Dallas	Txbl GO Pension Bonds Ser 2005C	02/16/2005	02/15/2024	$75,000,000	GO Ref Bonds Txbl Ser 2010	0%	$0	5.99%
Dallas	GO Refunding Bonds, Taxable Ser 2010	11/18/2010	02/15/2024	$77,670,000	$76,135,000	98%	$24,314,290	4.58%
				$477,017,609	**$265,840,086**	**56%**	**$611,738,353**	
El Paso	Txbl GO Pension Bonds Ser 2007	07/19/2007	08/15/2035	$101,240,000	$86,730,000	86%	$60,990,397	5.98%
El Paso	Txbl GO Pension Bonds Ser 2009	06/25/2009	08/15/2014	$111,545,000	GO Ref Bonds Txbl Ser 2014	0%	$0	3.60%
El Paso	GO Ref Bonds Txbl Ser 2014	01/16/2014	8/15/2014	$110,610,000	$102,425,000	93%	$53,566,114	2.64%
				$323,395,000	**$189,155,000**	**58%**	**$114,556,511**	
Houston	Txbl Pension Oblig Notes Ser 2004	12/17/2004	02/15/2006	$22,900,000	$0	0%	$0	4.35%
Houston	Txbl GO Pension Bonds Ser 2005	03/30/2005	03/01/2035	$57,165,000	$57,165,000	100%	$48,080,192	5.30%
Houston	Txbl Pension Oblig Bonds Ser 2006A	03/29/2006	03/01/2036	$63,740,000	$63,740,000	100%	$61,579,440	5.51%
Houston	Txbl Pension Oblig Bonds Ser 2007A	03/01/2007	03/01/2037	$63,800,000	$63,800,000	100%	$70,791,977	5.54%
Houston	Txbl Pension Oblig Notes Ser 2008	02/15/2008	02/18/2009	$35,050,000	$0	0%	$0	3.32%
Houston	Txbl Pension Oblig Bonds Ser 2008B	01/08/2009	03/01/2032	$20,190,000	$19,165,000	95%	$12,593,209	6.29%
Houston	Txbl Pension Oblig Ref Bonds Ser 2008A	01/08/2009	03/01/2032	$382,630,000	$363,255,000	95%	$238,830,986	6.29%
Houston	Txbl Pension Oblig Notes Ser 2010 (VR)	05/21/2010	11/16/2011	$20,100,000	Txbl Pub Impr Ref Bonds Ser 2011	0%	$0	N/A
*Houston	Txbl Pub Impr Ref Bonds Ser 2011B	10/27/2011	03/01/2041	$47,010,000	$45,075,000	96%	$28,926,857	4.04%
				$712,585,000	**$612,200,000**	**86%**	**$460,802,660**	
*Houston	Txbl Pub Impr Ref Bonds Ser 2011B							
	Breakout of Refunded Bonds:			**$1,512,997,609**	**$1,067,195,086**	**71%**	**$1,187,097,525**	
	(Non Pension) 2002	$15,170,000	33%					
	(Non Pension) 2003A-1	$10,250,000	23%					
	Pension Oblig Note Ser 2010	$20,100,000	44%					
		$45,520,000						

Source: Pension Review Board, *2017 Guide to Public Retirement Systems in Texas*

Voters need to be included in this conversation, especially since taxpayers could be obligated for full repayment in the event that the bonds fail to perform as expected. For this reason, the Foundation supports the passage of SB 957.

Thank you for your time. I look forward to answering any questions that you may have.