Pension Obligation Bonds and Ohio's 7.75% Defined Contribution Return Guaranty
Two Bad Schemes – One Underlying Theme

Pensions and Investments ran two seemingly unrelated articles on August 19, 2002. The first, by Fred Williams is titled: "Lousy Timing: Pension obligation bonds feel pinch of bad market. Mike Kennedy wrote "1,585 basis points shy: Ohio fund's guaranteed option misses the mark in its 1st year."

Each of these schemes is vulnerable at the moment because each has invested in stocks at a time when stock performance has been awful.

The point of my writing is that each of these is a bad idea – the same bad idea – at any and all times. Why do I say that without equivocation? How can I be so sure? Let us unbundle each of these transactions and see what is happening to the taxpayers of Ohio and to the many states and municipalities that have issued – and may be contemplating further issue of – pension obligation bonds.

The Ohio State Teacher's Plan is structured as a guaranty by the System's defined benefit plan of a 7.75% return to eligible participants of the System's 401k plan. Because the defined benefit plan is expected to earn 8% annually, after a 25 bp administrative cost, the guaranty is deemed to be costless to Ohio's taxpayers.

But let us look at the transaction from the taxpayer's point of view. In effect, the DB plan borrows the money invested by the 401k participants and invests it according to the asset allocation of the DB plan. The DB plan promises to pay 7.75% to the 401k no matter how the assets actually perform. To the taxpayers this is equivalent to having the DB plan borrow money at 7.75% in order to invest (partly) in stocks.

Now it should be clear why I lump pension obligation bonds and Ohio's guaranty together. States and municipalities that underwrite the bonds also borrow money in order to have their DB plans invest in stocks. Internal revenue rules have, since the mid-1980's made such borrowing taxable to the bondholders. Thus the public entity issuers of pension bonds borrow at their own taxable bond rates. Such rates are invariably greater than comparable Treasury rates.

Am I saying that these schemes are flawed because the DB plans are borrowing to invest in stocks. No. That is not what I am saying here. The common error of all these schemes is that they are borrowing much more expensively than they need to. These DB plans, if they wish to borrow money to invest in stocks, may do so in a variety of fashions and they need never pay much more than Treasury rates for such loans.

It is beyond the scope of this brief note to discuss the relative merits of the various ways in which DB plans can achieve leverage at a near-Treasury borrowing cost. Nonetheless, the following alternatives are available to virtually every DB plan: sell Treasury holdings of the plan; engage in debt-for-equity swaps with highly rated and well-collateralized counterparties; utilize various exchange-traded equity futures contracts; engage in securities lending investing the collateral in stocks.

Supporters of these plans may say that they are not borrowing. They may further say that they are not leveraging the risk to their taxpayers because the asset allocations of their DB plans remain no riskier than before. They may argue that my borrowing analogies differ because, when the DB plan borrows by any of my suggested methods, the resulting asset allocation is more risky.

But the capital market risk to taxpayers who support these DB plans is not correctly measured by the fraction or percentage of the plan assets invested in equities. The correct way to measure the taxpayers' risk is to look at the absolute equity exposure – a convenient measure might be equity-dollars per taxpayer. Looked at in this financially apt fashion, it is clear that pension obligation bonds and the Ohio guaranty are each increasing taxpayer risk in the same way as my more efficient borrowing approaches do. Borrowing expensively when one can borrow cheaply is a negative service to one's constituents.

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