Treasurer Nappier's response published in Governing - March 2013

The Bond Mistake

The January article, "The Great Gamble," put forth the blunt proposition that pension obligation bonds (POBs) are, by definition, a "fiscal gimmick." That blanket condemnation is unfortunate, because the article presents some of the worst examples of POBs gone wrong as evidence that any plan sponsor that issues them is engaged in naked speculation—or worse.

Connecticut is not, as the article suggests, licking its wounds. Rather, with an innovative approach to POBs, it has licked into shape its commitment to funding pension obligations well into the future.

As state treasurer and principal fiduciary of the state's retirement funds, I believe that the timing of the issuance of POBs in 2008 was warranted, and that the transaction represents a comprehensive solution to one of the most chronic issues that Connecticut faced—the growing unfunded liability of the Teachers' Retirement Fund (TERF).

Yes, timing could have been better. But we must be careful not to hastily minimize the merits of POBs during the first few years after issuance, particularly after navigating through the Great Recession. The old adage, "let's not count our chickens before they hatch," is apropos of the investment merits of POBs. Indeed, key features of this transaction have already begun to pay dividends. A few specifics bear underscoring:

- The most important upside of this transaction is the unique bond covenant that requires the state to fully fund the annual required contribution for as long as POBs remain outstanding. The $2 billion in proceeds generated by the sale of POBs have since grown to approximately $2.2 billion through December 2012. Moreover, had we not issued POBs, the 55 percent funded ratio of TERF, for example, would have deteriorated to roughly 46 percent at best.
- The average cost of POBs is 5.88 percent, and based on our 2012 projections, there is an 88 percent probability of exceeding that borrowing cost when the bonds mature in 2032, which represents a more reasonable hurdle to achieve versus the 8.5 percent actuarial assumed rate of return.
- The infusion of POB proceeds provided a much needed liquidity cushion, which was by design and strategy. The value of avoiding the need to liquidate long-term assets during the credit crisis and market declines? Immeasurable.

In the final analysis, the measure of Connecticut's success with its POB transaction will be judged by more than a simple mathematical comparison between debt service costs and the average return on invested bond proceeds. The added assurance of full funding of the state's annual commitment is no less significant, particularly during an era of great fiscal stress.

—Denise L. Nappier
Connecticut Treasurer