

## **SCORE Act for PERA Pension Obligation Bonds – SUMMARY**

**Section 1** – This act is known as the “Securitizing Contributions for Retirement Earnings Act.”

**Section 2** – Legislative Declaration:

- (a) The General Assembly is committed to maintaining the current employer contribution rates, preserving the actuarial funding ratio, and improving the future actuarial funding ratio of the state and school division trust funds;
- (b) The General Assembly has determined that issuance of bonds, requiring the inclusion of the covenants, and other related actions best achieve these goals; and
- (c) The General Assembly intends that the bonds are issued in one or more series in the maximum aggregate principal amount that the governor and the treasurer determine is financially prudent under prevailing market conditions within the interest rate, funding ratio, coverage ratio, time period and other parameters in the legislation.

**Section 3** – Adds new C.R.S. § 29-4-710.8.

**C.R.S. § 29-4-710.8 Powers of the board – issuance of bonds to fund the state division trust fund and the school division trust fund of the public employees’ retirement association – definitions – legislative declaration.**

(1) Defined terms include: “Association,” “Bonds,” “Required Covenants,” “School Division Special Fund,” “School Division Trust Fund,” “State Division Special Fund,” “State Division Trust Fund,” “Unfunded Accrued Actuarial Liability.” Specifically, “Required Covenants” are defined as covenants that must be included in the trust indenture, including:

- I. Covenant that immediate default occurs if fully implemented AED and SAED rates are reduced (unless reduction allowed because division is 103 percent funded as under C.R.S. § 24-51-411(8)), and
- II. Covenant that immediate default occurs if base employer contribution rates of 10.15 percent for state or school division are reduced (specifically, if statute amended to lower the percentage of the total payroll of state division employers or school division employers on which employer contributions are calculated from the percentage in C.R.S. § 24-51-401(1.7)), however, no default will occur if:
  - A. Most recent actuarial valuation states that state and school division trust funds are at or above 130 percent funded AND the reduced percentage maintains the then current funded ratio of the state division and school division trust funds, or
  - B. The rate is reduced due to a declared fiscal emergency under C.R.S. § 24-50-109.5, AND by the end of the fifth fiscal year following the fiscal year in which the percentage was reduced, employers have made additional employer contributions to PERA that equal: amount of reduction plus earnings on the reduction in the fiscal year where the lowered percentage became effective and

in each fiscal year during the cure period at the actuarial investment assumption rate used in the actuarial valuation of PERA for each such fiscal year. If additional employer contributions fail to be made by the end of the fifth fiscal year, a default occurs and the cure period shall not be extended for any reason.

(2) Upon receipt of required certifications, CHFA has the following powers: (a) issue bonds, including payment of principal, interest and premium, and other related fees and costs, to establish reserves, and to make deposits of the proceeds to the state and school trust funds, and (b) to enter into contracts with PERA related to the bonds issuance.

(3) Bonds issued are the obligation of CHFA, payable solely from the state and school division special funds at PERA (these funds hold the state and school divisions' AED and SAED contributions until debt service payments are made, at which point all excess AED and SAED flows to PERA trust funds). Bondholders are not entitled to access any other revenues of CHFA or the State. Bondholders are not entitled to access any assets or revenues of PERA other than moneys in the state and school special funds. Neither the bonds nor any contract entered into related to the bonds create an indebtedness or multiple-fiscal year debt by any state or school employer.

(4) No bonds shall issue until:

(a) Governor and treasurer deliver certificate that the issuance of bonds would reduce state division and school division UAAL.

(b) (I) Attorney general delivers certificate that a court has issued a final non-appealable order stating that neither the bonds issued, nor obligations of PERA, nor involvement of the State of Colorado would create a debt by loan under Section 3 of Article XI or a multiple-fiscal year debt violating TABOR.

(II) The General Assembly declares that the certificate delivered by the Attorney General is necessary and required, the issue is ripe, and the Governor and Treasurer must file for a judicial examination.

(III) Governor and Treasurer must file in Denver District Court asking for a judicial determination that neither the bonds issued, nor obligations of PERA, nor involvement of the State of Colorado would create a debt by loan under Section 3 of Article XI or a multiple-fiscal year debt violating TABOR.

(IV) The judicial determination process reflects a proceeding in rem (a proceeding that would determine the constitutionality of the bond issuance, rather than a proceeding to determine the rights of a particular party such as PERA or the State). Notice of the petition's filing would be by publication for 5 consecutive weeks in a local newspaper of general circulation in each of the State's planning and management regions, and also posted in the offices and on websites of PERA, the governor, and the treasurer. Any review of the trial court's determination shall proceed directly to the Colorado Supreme Court for review and the Colorado Supreme Court shall accept such application for review. Limited timelines apply.

(c) Governor and treasurer deliver the following certifications:

(I) (A) principal amounts, maturity dates, interest rates and dates of issuance have been approved, (B) aggregate principal amount of bonds issued does not exceed either the coverage ratio requirement or the principal amount required to increase the funding ratios of the state and school divisions to 100 percent, (C) the bonds mature no later than 40 years after date of issuance, and (D) the interest rate on the bonds is fixed, and the interest rate does not exceed the assumed rate minus 200 basis points.

(II) Governor and treasurer have approved use of proceeds and amounts to be deposited into state and school trust funds pursuant to the allocation requirements in the legislation.

(III) Governor and treasurer approved applicable redemption provisions.

(IV) Governor and treasurer approved terms of trust indenture, which must include required covenants. Events of default under the required covenants are irrevocable so long as bonds outstanding but do not give rise to remedies against CHFA, PERA, governor, treasurer, State, state or school division employers and do not allow for failure of performance by any of these entities.

(V) Governor and treasurer certify the terms of the contract between CHFA and PERA.

(VI) Governor and treasurer approve other terms/conditions applicable to the bonds issuance.

(d) For each series of bonds issued, governor and treasurer deliver certificate designating: bond issuance agents, underwriters, insurers, counsel and other parties as selected by governor and treasurer. Each must be selected through a competitive process (other than the rating agencies). Disclosure counsel shall be separate and independent from the bond counsel.

(e) State controller delivers a certificate stating that based on services provided by CHFA and amounts paid by PERA to CHFA, the bonds issuance is an exchange transaction not required to be considered in the benefit to burden analysis of financial accountability for determination of component unit status under GASB statements 14 and 61 and that CHFA will not be presented as a component unit of the state.

(5) Costs of issuance include reasonable costs incurred by PERA, CHFA, governor and treasurer.

(6) Certificates may be updated until the bonds are issued.

(7) If governor, treasurer, attorney general and state controller deliver certificates, CHFA shall issue bonds and take all other actions necessary.

(8) Maximum amount of bonds: 130 percent debt service ratio (revenue of AED and SAED is 130 percent of the debt service payments) in the fiscal year in which the bonds are issued and the following three fiscal years, and 150 percent debt service ratio (revenue of AED and SAED is 150 percent of the debt service payments) in each fiscal year thereafter. Revenue means the AED/SAED payments payable to PERA by state and school division employers as projected in the most recent actuarial valuation of PERA. Compliance with subsection (8) determined by treasurer based on advice of the financial advisor for the bonds.

(9) CHFA, PERA, governor, treasurer, state and school division employers may enter into any contracts/transactions necessary related to bonds issuance.

(10) No bonds may issue after December 31, 2018.

(11) Any court proceeding to review the issuance or proposed issuance of the bonds, execution of any contract or any other relief for actions under this legislation must commence within 30 days after the effective date of this act.

(12) Any provision of this legislation in conflict with existing law supersedes such law.

(13) General Assembly declares:

(a) Bonds do not violate TABOR because (i) CHFA is a special purpose authority, (ii) CHFA is not a district because it does not have the power to levy taxes, it is not subject to administrative direction of the state, and the general public does not vote with respect to actions of CHFA,

(b) Bonds are not a debt by loan under Section 3 of Article XI because CHFA not part of the state and because the bonds are payable from special fund,

(c) Involvement by the state in the bonds issuance does not change the findings that this transaction is exempt from TABOR and that the bonds are not a debt by loan.

**Section 4 – Adds new C.R.S. § 24-51-201.1 and C.R.S. § 24-51-201.3**

**C.R.S. § 24-51-201.1 Contracts with Colorado housing and finance authority – state and school division amortization equalization disbursement and supplemental amortization equalization disbursement special revenue funds.**

(1) If bonds are issued by CHFA, PERA shall enter into a contract with CHFA agreeing to make payments from the state and school division special funds. PERA's obligations under any such contract are limited and payable solely from the moneys held in the special funds. PERA shall not remit any amounts to CHFA over the amounts available in the special funds.

Sections (2) and (3)

- Creation of the state division special fund and the school division special fund. Moneys in each of the funds shall not be part of the trust funds of PERA and shall only be available to pay the debt service obligations under this legislation.
- Once PERA enters into the contract with CHFA, all AED and SAED moneys received by PERA from state and school division employers shall go into the state division special fund and school division special fund, as appropriate.
- Moneys in the state and school special funds shall be invested pursuant to C.R.S. § 24-36-113 and all interest and income shall be credited to the special funds.
- Once PERA makes payment from the special funds, any balance remaining in each special fund is transferred to the trust fund for that division. Moneys transferred from the special funds into the respective trust funds become trust assets and are not accessible by bondholders.

(4) Contract between PERA and CHFA shall contain the following terms:

(a) Bond proceeds shall be delivered to PERA and deposited in the state and school division trust funds, allocated in proportion to each division's respective percentage of the total annual contributions remitted to PERA by state division employers and school division employers based on the most recent CAFR at the time the bonds are issued, except that if the amount deposited either into the state or school trust fund would cause the funding ratio of that fund to exceed 100 percent, the amount that would cause the funding ratio to exceed 100 percent shall be deposited into the other fund. Board has authority to invest bond proceeds just like all other assets in the trust funds in accordance with C.R.S. § 24-51-206.

(b) Debt service payments from PERA to CHFA shall be as follows, on a monthly basis:

- Payment of no more than 1/5 of the next interest payment occurring within the next 6 months, and
- Payment of no more than 1/11 of the next principal or mandatory redemption payment occurring within the next 12 months
- Reasonable costs
- Amounts necessary to replenish reserves

Amounts payable from the special funds for each division shall be in proportion to the amount of proceeds deposited into that division. Obligations of each division to make payments are not interdependent or interchangeable and remain the separate obligation of that respective special fund.

(c) If either special fund has insufficient funds to make debt service payment(s), association is not liable to remit any additional amounts to CHFA.

(d) If either special fund has insufficient funds to make debt service payment(s) due to reduction in the AED or SAED by state statute, a default has occurred. Default remedies

do not include recovery of funds from PERA or any trust fund or other funds of PERA other than amounts in the special funds.

(5) If bonds are issued by CHFA, PERA shall take all actions reasonably required by governor and treasurer to cause the bonds to be issued.

(6) Before the bonds are issued, PERA shall cooperate with the governor and treasurer to provide an understanding of PERA's investment strategy for the proceeds, so that the governor and state treasurer can determine whether bonds should issue under current market conditions.

(7) No later than July 15, 2016 and no later than July 15 of each year thereafter, PERA shall submit:

- o A report to the General Assembly that includes information regarding the investment performance of the state division and school division in preceding calendar year, and
- o A report to the General Assembly and the governor's office of state planning and budgeting that includes (i) total amount of proceeds from the bonds issuance, (ii) total amount applied in each fiscal year to payment of the bonds, and (iii) cost of issuance and administration of the bonds.

(8) General Assembly declares:

(a) Obligations of PERA under a contract entered into with CHFA do not violate TABOR because (I) PERA is a special purpose authority, (II) PERA is not a district because it does not have the power to levy taxes, it is not subject to administrative direction of the state, and the general public does not vote with respect to actions of PERA, and (III) employer contributions paid to PERA do not affect exemption from TABOR because such contributions are in exchange for PERA's payment of benefits and are not grants;

(b) Obligations of PERA under a contract entered into with CHFA are not a debt by loan under the Colorado constitution because PERA is not part of the state and because the obligations are payable from a special fund; and

(c) Involvement by the state in the bonds issuance does not change the findings that this transaction is exempt from TABOR and that the bonds are not a debt by loan.

**C.R.S. § 24-51-201.3 Timely payment of certain school district obligations to the public employees' retirement association.**

In the event a school division employer fails to pay the AED and SAED, treasurer has the authority to withhold necessary payments to the employer and remit the necessary AED and SAED to PERA.

**Section 5** – Adds (12) to C.R.S. § 24-51-204.

**C.R.S. § 24-51-204. Duties of the board.**

(12) The PERA board, PERA, the state, the governor, the treasurer, and CHFA are immune from claims arising from enforcement and implementation of this legislation.

**Section 6** – Adds (8) to C.R.S. § 24-51-205.

**C.R.S. § 24-51-205. General authority of the board.**

(8) PERA board may enter into contracts with CHFA regarding the bonds issuance.

**Section 7** – Adds (2)(d) to C.R.S. § 24-51-207.

**C.R.S. § 24-51-207. Standards of conduct.**

(2)(d) Board's entry into contract with CHFA regarding the bonds issuance and any actions that are reasonable and necessary to fulfill PERA's obligations under that contract do not constitute a breach of the board's duties or standards of conduct.

**Section 8** – Amends (8) in C.R.S. § 24-51-411.

**C.R.S. § 24-51-411. Amortization equalization disbursement.**

(b) Amends the PERA AED/SAED statute to provide that the AED and SAED shall not be lowered under the schedule, if reduction would cause AED and SAED in immediately preceding fiscal year to fall below amounts necessary to fund the amounts payable pursuant to the bonds legislation during the current or any future fiscal year.

(c) Provides that so long as bonds outstanding, AED/SAED shall not be reduced if reduction would cause amount of AED/SAED payments for the division to fall below minimum amount require to meet applicable coverage ratio regarding outstanding bonds or new series of bonds.

**Section 9** – Amends C.R.S. § 24-51-1010.

**C.R.S. § 24-51-1010. Increase in benefits – actuarial assessment required.**

- In the event that bonds have been issued: before increasing benefits provided by PERA above the levels that are in effect on the date the SCORE Act is passed, the General

Assembly shall cause an actuarial assessment to be conducted to ensure that so long as the bonds are outstanding, the increases in benefits would not cause the actuarial value of assets of the state or school division trust funds to decline below 130 percent of the actuarial accrued liabilities of the state or school division trust funds.

- In the event that bonds have been issued: upon direction from the Senate president and the speaker of the House, an actuarial assessment of PERA shall be conducted to determine whether an increase in benefits above the levels in effect on the date the SCORE Act is passed would cause the actuarial value of assets of the state or school division trust funds to decline below 130 percent of the actuarial accrued liabilities of the state or school division trust funds.

**Section 10 – Safety Clause.**





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April 14, 2015

## Memorandum

**To:** Greg Smith and Karl Paulson, Colorado PERA  
**From:** Jill Jaworski, Dan Kozloff and Dan Berger  
**CC:** Jim Link, Chris Blackwood  
**Re:** GFOA Recommendation regarding Pension Obligation Bonds

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The GFOA recommends against the issuance of Pension Obligation Bonds by state and local governments; please see the attached advisory guidance. The following addresses each of their reasons in the context of the proposed issuance of Pension Obligation Bonds by the State of Colorado.

**1. 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 government.**

While not an issue for the PERA Board, it is the objective of the POB from the issuer's perspective to create an arbitrage (investment return in excess of cost of taxable POB issuance) to improve the overall funded status and thus minimize the ongoing contribution requirements of the issuer going forward.

Issuance of POBs does expose the issuer to the risk that investment returns of POB proceeds could underperform expectations over time. POB's must be viewed as a long-term strategy and history shows that over a long-term period (30-year), equities predominantly outperform POB funding costs (taxable bond indices); whereas shorter term views (5-year) provide more erratic performance results and greater risks. Measuring the success of the issuance can be done after all debt has been retired and the investment results are tabulated.

**2. 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.**

The proposed structure as outlined in the draft legislation for POBs in Colorado allows for fixed rate bonds only and does not allow for variable rate or derivative structures. Swaps and derivatives are most commonly utilized to hedge variable rate bonds as part of a strategy



to reduce overall funding cost. That strategy would not be allowable under the current draft legislation.

- 3. Issuing taxable debt to fund the pension liability increases 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.**

Issuance of POBs would increase the State's outstanding debt. It would also reduce the State's unfunded liability to the State and School Divisions of COPERA, which under the new GASB standards would reduce the unfunded liability amounts that will be reflected on the balance sheet of on employers' financial reports. The rating agencies have noted that Colorado has a low state debt burden, which is offset by high unfunded pension liabilities. As the POBs would offset that liability, the transaction is not expected to impact the State's overall debt capacity. Additionally, this transaction securitizes funds that go solely to PERA and are not used for other purposes. As such, the transaction does not directly impact any of the State's existing borrowing programs.

The market standard for taxable bonds is a make-whole redemption feature which limits the financial benefit of potential future refinancing opportunities if interest rates decline. They do allow the issuer to retain the flexibility to restructure the bonds in the future. Taxable bonds can be sold with par call redemption features typical of tax-exempt debt, but use of those call options will increase the yield (cost) of the bonds.

- 4. POBs are frequently structured in a manner that defers the principal payments or extends repayment over a period longer than the actuarial amortization period, thereby increasing the sponsor's overall costs.**

The funding period for the State and School Divisions is currently in excess of 30 years. Based upon current projections of AED and SAED levels, a POB issuance can be structured to mature in 30 years or less. Additionally, investors will require adequate revenue coverage over POB payments. A structure modeled to have a constant coverage level will not have any greater deferral than the current projected AED and SAED deposits. The POB transaction is a securitization of an existing revenue stream and the structure has been proposed specifically to reduce the sponsors' funding cost and amortization period.



5. **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.**

While issuance of POBs does turn a “soft” liability into a “hard” liability, numerous rating agency metrics explicitly factor in pension liabilities, and incorporate current and potential future burden of benefits into their process. Rating agency reports for the State have drawn attention to the current pension funding levels.

The State has put in place a plan to address pension funding shortfalls through the AED and SAED payments. The proposed POB issuance is not a stand-alone solution but rather an outgrowth of the State’s larger and long-term strategic plan to address the unfunded liabilities. As the POB is not being issued for budgetary relief and will not disrupt or divert the flow of AED and SAED payments, the proposed transaction does not fit the profile of the type of POB transactions which have drawn rating agency criticism.

# Securitizing Contributions for Retirement Earnings (SCORE) Act

## House Bill 15-1388

### OVERVIEW

Bonds are a very common financial instrument for all levels of government in Colorado and across the country. They are used for a variety of purposes and there are many types of bond financing structures that are intended to serve different financial goals.

In Colorado, representatives from the Governor's Office, the Treasurer's Office, the Attorney General's Office, the Colorado Coalition for Retirement Security, and Colorado PERA have spent almost a year in a collaborative effort studying potential bond proposals that could be used to take advantage of the spread between the low interest rates required to pay for the bonds and the potential for higher long-term returns received from investing the proceeds. Under the newly introduced SCORE Act, current employer and employee contributions into PERA would be used to pay for the bonds issued at a lower fixed interest rate. All income and the contributions above the amount needed to repay the bonds would flow to the PERA trust funds to be applied to continue shrinking the unfunded portion of the pension liabilities at no new cost to taxpayers, the state, employers, employees, or retirees.

### GOALS OF SCORE ACT

- » Strengthen Senate Bill 10-001 (SB 1)
  - Issuance of the bonds would improve PERA's funded status and could reduce the amortization period on unfunded liabilities resulting in potential long-term future savings for employers and employees.
  - Bonds will provide for contribution security by ensuring the necessary contributions are maintained to reach full funding.
  - Issuing the bonds would not incur any new cost to taxpayers, the state, employers, employees, or retirees.
- » Ensure fiscal discipline
  - As proposed, the bonds could reduce the amortization period by as much as five years, saving employers \$4.5 billion in today's inflation-adjusted dollars.
  - Without bonds, employers would have to pay approximately an additional 2–3 percent in contribution rate increases today in order to similarly reduce the amortization period.

- » Provide transparency
  - Bonds will only be issued upon successful completion of a legal validation proceeding, providing for a final, non-appealable court order.
  - The debt service to pay for the bonds will be known at the time of issuance because only fixed-rate bonds are permitted.
  - Proceeds will be managed by PERA investment professionals with the oversight of the PERA Board of Trustees only for the benefit of its members.

### HOW THIS PROPOSAL DIFFERS FROM BOND ISSUANCES IN OTHER STATES

- » Unlike in many other states, these bonds would not cost anyone any new money, nor would they free up money to pay for other short-term state budget priorities.
- » These bonds do not provide for a contribution "holiday." Under the proposal, an issuance of bonds secures the bond payments through an explicit bond covenant designed to maintain the existing employer and employee contribution rates into PERA.

### ADDITIONAL INFORMATION

- » PERA is sustainable today and into the future as a result of the reforms passed in SB 1. As proposed, the issuance of bonds could improve the funded ratio and shorten the time frame for PERA to become fully funded by taking advantage of low interest rates and PERA's investment program.
- » As proposed, the issuance of bonds is intended to result in a funded status of approximately 70–80 percent in the State and School Divisions, and ensures PERA will remain one of Colorado's best investments.
- » The bonds would be issued by the Colorado Housing and Finance Authority (CHFA), under the direction of the Governor and State Treasurer.
- » PERA would invest the funds as it does today—in a globally diversified portfolio with an investment time horizon that matches the fiscal discipline of the bond issuance.



# Actuarial Impact of Bonds to Colorado PERA

The following tables are a summary of the actuarial analysis provided to Colorado PERA by Cavanaugh MacDonald Consulting, LLC regarding the impact on the State and School Divisions of PERA of differing bond issuances. The projection information is based on the demographic and economic assumptions used by the PERA Board with one exception. The estimated rate of return used for calendar year 2014 is 5.5% with the target rate of return of 7.5% used for subsequent calendar years. The projections assume the bonds are issued at a 4.39% debt service, a rate derived by PERA's Financial Advisor, PFM, who has expertise in the municipal bond market.

The three scenarios presented are:

- No POB issuance
- Total POB issuance of \$6,000,000,000, including fees, with 38.5% allocated to the State Division and 61.5% allocated to the School Division
- Maximum issuance—\$9,954,601,671 total POB issuance, including fees, with \$4,030,451,336 allocated to the State Division and \$5,924,150,335 allocated to the School Division

State Division					
Issuance Size	Funded Ratio (2016)	Amortization Period (Fully Funded By)	ARC Percentage at Issuance	Year Full ARC Reached	Additional Contribution Increase*
No POB—Current Status	59%	36 Years (2052)	90%	2026	N/A
\$6 Billion Total	69%	32 Years (2048)	93%	2025	1.00%
Maximum Issuance	76%	30 Years (2046)	96%	2024	2.17%

School Division					
Issuance Size	Funded Ratio (2016)	Amortization Period (Fully Funded By)	ARC Percentage at Issuance	Year Full ARC Reached	Additional Contribution Increase*
No POB—Current Status	62%	35 Years (2051)	92%	2022	N/A
\$6 Billion Total	72%	31 Years (2047)	95%	2020	1.23%
Maximum Issuance	78%	29 Years (2045)	98%	2017	2.00%

\* The Additional Contribution Increase is the additional level percentage of payroll contribution required annually in the No POB Scenario to reach the same fully funded status at the same point in time as the scenario in question.

Cavanaugh MacDonald also provided additional sensitivity analysis on these baseline scenario runs by modifying the following assumptions:

Four different market rates of return for the period of January 1, 2016 through December 31, 2054:

- Lower Returns—at both 5.5% and 6.0%
- Baseline Returns—7.5%
- Higher Returns—9.00%
- Shock Returns—PERA historical returns for the period of 2008-2014, followed by 7.5% thereafter

Four different costs of debt service:

- Lower Debt Service (3.89%)
- Baseline Debt Service (4.39%)
- Higher Debt Service (4.89%)
- Maximum Debt Service (5.17%)



# Promoting Fiscal Responsibility: The Unique Nature of Colorado's Bond Proposal

Colorado PERA is one of the state's best investments. A not-for-profit economic engine, it consistently delivers value to Colorado's largest workforce and is a vital and stable contributor to the state's economy. Reforms approved by the Colorado General Assembly in 2010 (Senate Bill 10-001 [SB 1]) put PERA on a sustainable path going forward, and it will be fully funded in a reasonable period of time. Proceeds from the issuance of bonds will shorten the time frame to achieve full funding and could provide significant savings to PERA members and employers.

## THE SECURITIZING CONTRIBUTIONS FOR RETIREMENT EARNINGS (SCORE) ACT

Bonds are a common financial instrument for all levels of government in Colorado and across the country. A wide variety of bond financing structures allow governments to achieve many different financial goals.

In Colorado, representatives from the Governor's Office, the Treasurer's Office, the Attorney General's Office, the Colorado Coalition for Retirement Security, and PERA have spent over a year in a collaborative effort studying potential bond proposals that could be used to take advantage of the spread between the low interest rates required to pay for the bonds and the potential for higher long-term returns received from investing the proceeds.

Under the SCORE Act, current employer and employee contributions into PERA would be used to pay for the bonds, and bonds would improve PERA's funded status and could reduce the amortization period on unfunded liabilities, resulting in potential long-term future savings for employers and employees.

## PERA BOARD POSITION

The PERA Board of Trustees, after a lengthy due diligence process and after receiving input from bond finance experts, actuaries, and independent legal counsel who specialize in bond transactions, voted to support the potential bond legislation.

In their official motion of support, they added, "Furthermore, staff is authorized to inform the legislative bodies and the Governor of the Board's

support while acknowledging that the funding decisions of PERA are the exclusive responsibility of the General Assembly and the Governor. The bill strengthens reforms set forth and agreed to through a collaborative bipartisan process of shared sacrifice in Senate Bill 10-001 and continues the path toward full funding of the retirement system serving Colorado's public workforce. The Board believes PERA can successfully incorporate and manage the proceeds of any bonds deemed appropriate for issuance, in accordance with PERA's long-term investment strategies for the exclusive benefit of PERA's members and benefit recipients."

## WHAT IS A PENSION OBLIGATION BOND (POB)?

POBs are taxable bonds that some state and local governments have issued as part of an overall strategy to fund the unfunded portion of their pension liabilities by selling debt. The use of POBs rests on the assumption that the bond proceeds, when invested with pension assets in higher-yielding asset classes, will be able to achieve a rate of return greater than the interest rate owed over the term of the bonds.

## WHAT ARE THE BENEFITS?

The SCORE Act strengthens the state's financial commitments under SB 1 by injecting bond proceeds into PERA's State and School Division trusts, and providing for contribution security by ensuring the necessary contributions are maintained to reach full funding—all at no new cost to taxpayers, the state, employers, employees, or retirees.

The proposed legislation would improve the funded level of the State and School Divisions to between 70 and 80 percent, compared to about 62 percent currently. PERA will be able to invest the money from the bonds, along with other assets in the trust funds, to earn an estimated 7.5 percent annual average return over the duration of the bonds.

The SCORE Act could reduce the amortization period in the State and School Divisions by as many as five years, saving employers \$4.5 billion in today's inflation-adjusted

# Promoting Fiscal Responsibility: The Unique Nature of Colorado's Bond Proposal (continued)

dollars. Without bonds, employers would have to pay approximately an additional 2–3 percent in contribution rate increases today in order to similarly reduce the amortization period.

## WHAT IF THERE IS A DEFAULT ON THE BONDS?

### IMPACT ON STATE AND TAXPAYERS

Because the Colorado Housing and Finance Authority (CHFA) is the issuing authority for these bonds, any potential default would be a technical default. That means the State's credit rating could be impacted, potentially increasing the cost to borrow money through future bond issuances.

### IMPACT ON PERA

It could take PERA longer to become fully funded if it is not receiving the required contributions.

## WHAT ARE THE RISKS AND HOW IS PERA PROTECTED?

### FINANCIAL

The success of POBs depends on pension returns averaging more than the cost of financing the debt over the term of the bonds. Over any multi-year period (3-, 5-, 10-, 30-year), PERA's investment returns exceeded the anticipated interest rate for the bonds. PERA averaged an annualized rate of return of 9.5 percent over the last 30 years—approximately double the anticipated interest rate for the bonds.

### TIMING

POBs involve considerable timing risk, as the proceeds from the issuance are typically invested at once into the pension plan. Under the SCORE Act, the bonds will only be issued if and when deemed prudent, and could be sold to the market over time in smaller denominations as fixed-rate bonds only. With the repayment schedule known at the time of issuance, the proposal would avoid exotic financial transactions such as swaps and derivatives that plagued some issuances in other localities.

### FLEXIBILITY

While the issuance of a POB does not change the total indebtedness of the state, it does change the nature of the indebtedness by creating an inflexible debt with required debt payments from PERA's current flexible unfunded actuarial accrued liability. Locking in the employer and employee AED and SAED contributions is a unique feature of the proposal, distinguishing it from

other bond initiatives around the country. Securing these contributions ensures there is a steady revenue stream for debt service throughout the duration of the bonds.

### POLITICAL

If the government uses the POB to fully fund the pension, it may end up with a pension system having more assets than liabilities, creating the potential for demands to enhance the benefit, despite the fact that the underfunding just moved from the pension plan's balance sheet to the sponsor's balance sheet. If bonds are issued, it would still take years before PERA reaches full funding. Current law already specifies how employers, members, and retirees would benefit once full funding is reached. PERA's transparency and regular reporting to legislative oversight committees will ensure a comprehensive view of PERA's financial situation continues into the future.

*Source: Adapted from the Center for State and Local Government Excellence, An Update on Pension Obligation Bonds*

## WHAT DOES THIS MEAN TO PERA?

The SCORE Act strengthens the reforms and shared sacrifices of SB 1 by ensuring the employer and employee contributions will be paid in full throughout the duration of the bonds, at no additional cost to employers or employees.

The issuance of bonds is intended to increase the funded status of PERA's two largest divisions, representing over 85 percent of PERA's total membership. It also proactively deals with the new GASB standards, allowing employers to significantly reduce their reported share of the accrued unfunded liability and improving their future balance sheets.

The Governor, State Treasurer, and General Assembly are recognizing PERA's investment program's proven track record of earning returns in excess of the anticipated interest rate for the bonds.

PERA continues to be one of Colorado's best investments, delivering a big economic value at a low cost to communities across the state.

*continued on the next page*

## Promoting Fiscal Responsibility: The Unique Nature of Colorado's Bond Proposal (continued)

### ADDITIONAL INFORMATION

The SCORE Act does not provide for a contribution "holiday." Under the proposal, an issuance of bonds secures the AED/SAED payments through an explicit bond covenant designed to maintain the existing employer and employee contribution rates into PERA.

The bonds would be issued by CHFA, under the direction of the Governor and State Treasurer. PERA would invest the funds as it does today in a globally diversified and balanced portfolio, with oversight from the PERA Board of Trustees and only for the benefit of its members. Investment institutions and individuals who purchase the bonds would receive regular principal and interest payments at the rate determined by the market when the bonds are issued.

The bonds would not be issued until the Colorado courts have reviewed the legislation under an expedited review process called a Validation Proceeding and determine the legislation does not violate Colorado law. This process provides for a final, non-appealable Court order before the bonds are issued.

Only the State and School Divisions are affected by the SCORE Act. The Local Government Division currently has a much shorter amortization period and contains many different governmental entities, while the Judicial Division is relatively very small. The DPS Division issued their own PCOPs (Pension Certificates of Participation, a variation of POBs) prior to merging with PERA.

This may be one of the largest POB issuances (in aggregate) in the country, but it is unique due to its covenant in protecting the revenue stream to pay for the bonds, and it is not being issued out of necessity, but rather as an opportunity to benefit from PERA's excellent investment program in a low-interest rate environment. Currently, contribution rates can be changed at the discretion of the General Assembly and the Governor via passage of legislative bill.

The SCORE Act includes a covenant prohibiting any reduction in the employee and employer contributions while the bonds are outstanding. It prohibits any reduction in the base employer contribution rate, unless the General Assembly declares a "fiscal emergency" and has to reduce the base contribution rate for short period of time. If such a reduction occurred, the employer

would have five years to cure the deficit and repay the funding to the extent necessary to make the PERA trust funds whole, including interest earnings on the unpaid contributions at the assumed rate of return.

### KEY POINTS

PERA is sustainable today and into the future as a result of the reforms passed in SB 1. Bonds shorten the timeframe to become fully funded by taking advantage of low interest rates and PERA's investment program. The SCORE Act is a unique proposal that includes a covenant strengthening the State's obligation to pay all existing contributions as established by SB 1, issuing only fixed-rate bonds, and providing for a validation proceeding to ensure maximum legal protection. Bonds strengthen the reforms implemented in SB 1 while reducing the amortization period to become fully funded—at no new cost to taxpayers, the state, employers, employees, or retirees. The issuance of bonds is intended to result in a funded status of approximately 70–80 percent in the State and School Divisions, and ensures PERA will remain one of Colorado's best investments.