City of Norwich
Pension Obligation Bonds
Frequently Asked Questions

Last Updated: July 1, 2021

Q. What is a Pension Obligation Bond?

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

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

A POB is similar to refinancing a mortgage or car loan to take advantage of low interest rates to save money. 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, typically 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 return on pension assets	6.25%
Estimated bond true interest cost	3.00%
Difference (arbitrage)	3.25%

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

A significant portion of the City's 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. POBs are issued only to address this Unfunded Accrued Liability. The City will still have an obligation to fund pension benefits as City employees earn them in future years.

Q. What is the City of Norwich proposing and why?

The City is proposing to issue $145 million of POBs in order to fund 100% of the Unfunded Accrued Liability and to pay those bonds off over 25 years. This approach is being used by other municipalities in Connecticut and across the country to address challenges with pension funding.

The City's pension plan currently has a significant Unfunded Accrued Liability. It is important to note that the last valuation prepared by the City's actuary (as of July 1, 2019) identified an Unfunded Accrued Liability of $122 million and the plan's funded ratio was 60.1%. This calculation was based on an annual investment return assumption of 7.25%. With the issuance of POB's, a more conservative investment return assumption of 6.25% is proposed. This more conservative assumption results in an increase to the Unfunded Accrued Liability; the City's actuary estimates that as of July 1, 2021 the Unfunded Accrued Liability will be $145 million, which is the amount the City is proposing to fund by issuing POBs.

The City has been diligent over the past several years in taking steps to strengthen the pension fund, including ramping up contributions over the past five years to meet the full Actuarially Determined Employer Contribution and bargaining with City employees for lower-cost retirement benefits.

At the same time, the City has taken measures to ensure that the accrued liability is measured responsibly. Actions taken, such as the gradual reduction of the investment return assumption and the use of updated mortality tables, have increased the accrued liability and therefore slowed improvement in the funded ratio. Despite all the changes and actions mentioned, the City has been unable to increase the funded level to an appreciable degree. The steady increase in the City's annual contribution to the pension trust is a significant and growing burden on the annual budget. Norwich is not alone: these same factors have been at work in many municipal pension plans across the country.

Given the size of the Unfunded Accrued Liability, the City's annual contribution to the pension trust is one of the City's most significant cost drivers. The issuance of POBs would allow the City to fund its pension obligation at a lower annual cost, resulting in tax relief with the benefit of a fully funded pension plan. The plan's investment return assumption, based on a conservative 6.25% rate, could yield net present value savings of $43 million over a 30-year period. *These savings are not guaranteed.* Actual savings will depend on actual future investment performance. Given market return history, it is certain that there will be periods of strong investment returns and periods of poor or even negative returns.

Q. What is the City doing to address the potential risks of issuing POBs?

The City is recommending two important steps to protect the City's finances in periods of poor market returns:

- When the POBs are issued, the proceeds will be gradually invested in the market over a period of 18 to 36 months. This avoids the risk of buying investments when the market is at a peak and suffering losses if the market drops.
- The City will establish a pension reserve fund with the amount that has been budgeted as a pension contribution for fiscal year 2021-22. If there are market losses that would cause the City's pension cost to increase sharply, the pension reserve fund will help pay the pension contribution. And if there are market gains that would cause the City's pension contribution to fall, the savings will be used to shore up the pension reserve fund. At the end of the bond repayment period, if there is money left in the pension reserve fund it can be put into the pension trust or returned to the City.

Q. What other considerations are there for the City's POBs?

- Much of the City's annual contribution to the pension plan is devoted tofully funding the Unfunded Accrued Liability over a long period of time
- The City's current funding methodology is considered a "soft" debt: there is no requirement to fully fund the pension plan
- A POB is a "hard" debt: the City must pay the debt service and is required to pay the annual Actuarially Determined Employer Contribution
- The POB adds millions of dollars to the pension plan's assets in order to make it fully funded
- The analysis shows that borrowing funds at approximately 3% and investing the proceeds with an expected long-term investment return of 6.25% will save the City money over the long term

Q. Why Pension Obligation Bonds do not work for some municipalities and how would the City address these potential pitfalls?

POBs have been issued by many municipalities and some of them have failed because of the pitfalls described below.

Potential Pitfall	City's Plan
Municipality issues POBs without adequate up-front analysis.	The City's actuary has completed rigorous testing using a financial model that shows that the City would exhaust the pension reserve fund in just 14% of 10,000 scenarios and would have a lower overall net present value cost by issuing POBs rather than not issuing POBs in 70% of the 10,000 scenarios.
POBs issued by a municipality with pension cash flow problems and limited financial flexibility.	The City of Norwich is financially sound, with an AA bond rating from Standard & Poor's, and its pension fund does not have cash flow issues.
POBs issued during unfavorable interest rate conditions.	The City currently has a unique opportunity to take advantage of today's historically low interest rates.
Municipality uses unrealistic, aggressive asset growth assumptions.	The City has been lowering its investment return assumption for years and will further lower it to 6.25% in FY22.
Municipality does not have a plan to mitigate potential future increases in pension contributions during economic downturns.	The City would create a pension reserve fund to provide a buffer against large increases in the City's pension cost due to market downturns or other future changes in the pension liabilities. The pension reserve fund is described in more detail below.
Municipality immediately invests all POB proceeds into the pension fund portfolio immediately before a market downturn.	The POB proceeds will be deposited immediately into a cash account within the pension trust and will be gradually and carefully invested into the market portfolio (stocks, bonds, real estate funds) over 18 to 36 months in order to hedge against adverse market conditions.
Municipality structures the POBs for large up-front savings that end up costing it more money in the long term.	The planned 25-year payback of the POBs and the creation of the pension reserve fund are designed to produce stability and the highest probability of long-term savings.

Q. What are the details of the pension reserve fund and pension contribution funding plan?

Initial contribution to the pension reserve fund

The pension contribution that the City has budgeted for FY 2021-22 ($13.7 million) will be deposited into the pension reserve fund. The balance in the pension reserve fund will be tracked by divisions (Norwich Public Schools, Norwich Public Utilities, Police, Fire, and General City).

Adverse market performance (relative to the 6.25% assumption) may trigger use of the pension reserve fund. Given the annual fluctuation of investment gains and losses, the plan may become over- and underfunded during some years over the life of the bonds.

Use of pension reserve funds

The reserve fund will be used to shield the City from contribution volatility by picking up any year-over-year increases in the City's pension cost of more than 3%. For this purpose, "pension cost" means the City's contribution to the pension trust plus the City's payment to pay off the POBs.

Example:

- A pension cost increase of 1.5% would result in the City's budgeted pension cost increasing by 1.5%
- A pension cost increase of 5% would result in City's budgeted pension cost increasing by 3% with the pension reserve fund contributing the remaining 2% increase

What if the City's pension contribution *Decreases*?

If the City's pension contribution *decreases* from one year to the next, the *difference* will be deposited:

- first into the pension reserve fund until the pension reserve fund is at least 6% of the pension accrued liability,
- second, it would be deposited as an additional pension contribution until the pension fund is at least 115% funded,
- and, third, it would be deposited into the OPEB fund as an additional contribution until the OPEB fund is at least 115% funded.

If all three of these criteria have been met, the remaining difference will be a reduction in budgeted expenditures.

Q. What are the details of the financial analysis that has been done on the City's pension fund?

In order to analyze the trade-off between cost savings and increased investment risk, the City's Consulting Actuary constructed 10,000 hypothetical scenarios of possible investment performance over the next 30 years. For each scenario, the pension plan's investments, liabilities and contribution levels were projected over a 30-year period. The scenarios were sorted by outcome so the most favorable outcomes, the least favorable outcomes, and the middle-of-the-road outcomes could be identified.

The same analysis process was used to look at how each of the elements of the POB package would impact the likely outcome:

- Amount of POB to issue (not to exceed $145 million)
- Length of bond term (25 years)
- Interest rate on bond (estimated at 3%)
- Initial amount to deposit into the reserve fund ($13.7 million)
- Trigger for accessing the reserve fund to control budgetary volatility (3% of year- over-year pension cost increase)
- Trigger for making deposits into the reserve fund (decrease in pension contribution from the previous year)

The baseline projected total 30-year Net Present Value savings based on previously-stated bond rates and investment return assumptions is $43 million.