OPEB Bonds: A Cautionary Tale for Cities

By Rebecca Otto, State Auditor

The 2008 Legislature authorized the creation of both revocable and irrevocable trusts to pay Other Post Employment Benefits (OPEB). This new legislation also permits public employers to issue bonds to amortize their OPEB actuarial liability over a period of years in a more manageable and predictable manner. The option of issuing bonds to fund a city’s OPEB actuarial liability can be a powerful tool but it can also be a rollercoaster to disaster, as a few school districts in Wisconsin are learning.

The appeal. Over the past two years a number of public entities in Minnesota have been approached by brokers with attractive presentations encouraging the entities to consider arbitrage plans involving the issuance of OPEB bonds. The plans entail the entity issuing OPEB bonds, and then investing the proceeds in an investment security paying a higher interest rate than those bonds.

It’s an appealing scenario: the difference between the two interest rates would produce income that the entity can then use to pay its OPEB liability. Instead of just saving funds to pay their OPEB liability, the prospective investors are told that they will actually be generating funds to pay this liability. Since OPEB bonds are taxable, this form of arbitrage is not a problem with the Internal Revenue Service. Until the 2008 legislative session, the possibility of participating in these types of arbitrage deals did not exist for Minnesota public entities.

Where the risk is. Borrowing money to make investments is rarely a good idea. Placing millions of borrowed public dollars at risk in investment schemes is never a good idea. Five school districts in Wisconsin are learning the hard way.

In 2006, the school districts of Kenosha, Kimberly Area, Waukesha, West Allis-West Milwaukee and Whitefish Bay all got involved in an OPEB arbitrage proposal. They issued bonds and invested the proceeds—$200 million, between the five districts—in Certified Debt Obligations (CDOs), which had been presented to the districts as “safe investments.” The CDOs were placed in a trust for the bondholders, and the districts promised to maintain the value of the securities in that trust at 101 percent of the value of the outstanding bonds.
In 2007 the collapse of the subprime market caused the CDOs to lose value. The loss in value of the securities in this trust is now estimated at $120 million. The districts must place that amount in securities or other collateral into the trust or they will be in default on the bonds. These districts thought that by participating in this scheme they could finance part of their OPEB liability without raising property taxes. Now they face the possibility of raising property taxes to provide collateral for bond investors—while their own OPEB liability remains large. For example, the Kenosha School District, according to its May 2007 board minutes, had a projected OPEB actuarial liability of $126 million. According to a Milwaukee Journal Sentinel article from April 5, 2008, the district was estimated to owe $8 million in additional collateral to cover losses from its investments or it would be in default on $28.7 million in OPEB bonds. At that time, the combined projected loss to the five districts was $53 million; since then, the projected loss has ballooned to $120 million. Presumably the prorated liability of Kenosha and the other districts has ballooned as well.

As if this were not enough, the losses to the arbitrage trust are now affecting other aspects of school district operations. It was reported in the Sept. 9, 2008 Milwaukee Journal Sentinel that the Waukesha School District has had its bond rating downgraded by Moody’s Investor Services. District officials estimated this will result in over $300,000 in additional annual debt service costs for the district’s routine borrowing.

Use Caution. Cities in Minnesota should be extremely cautious of any proposal that involves the issuance of OPEB debt and then investing the proceeds in securities with a higher interest rate. Generally, the difference between interest rates represents a difference in risk. If you sell bonds at one rate of interest and invest in debt paying a higher rate, you are moving up the risk ladder and putting public funds at risk.

One characteristic of these schemes is that bond proceeds are not placed in an OPEB trust, but instead are placed in a trust for the bondholders. The bond proceeds themselves are never intended to be used to pay OPEB benefits in these situations. It is only the profit they generate that is to be used for OPEB. By making sure that bond proceeds are placed in an OPEB trust, cities can avoid some of the arbitrage schemes.

ADDITIONAL INFORMATION AND LINKS:

Another step cities can take is to have an independent financial advisor review any proposed issuance of OPEB bonds. This financial advisor should not be involved in the issuance of the bonds. This precaution is recommended by the GFOA in their memo entitled Need for Considerable Caution in Regards to OPEB Bonds (2007) at: http://www.gfoa.org/downloads/corbaopebbonds.pdf

The investment marketplace can be very complicated. Caution and additional professional advice are prudent courses of action for those issuing public debt and investing public funds.

There is also an article entitled Wisconsin Schools Flunk Investments 101 by Girard Miller, author of GFOA book “Public Investing,” at: http://www.governing.com/articles/0804gmillerc.htm