On Saturday, June 25th 2005, the voters of the state of West Virginia will be asked to approve or defeat an amendment to the state's constitution authorizing the sale of $5,500,000,000 in general obligation bonds.

The purpose of the bonds is to cure an accrued unfunded liability in the state's pension plans by reinvesting bond proceeds in higher-yielding financial instruments and using the net profits from arbitrage to reduce scheduled contributions to the pension plans.

Following are pertinent questions which I think the voters need to consider before casting their votes:

From Supreme Court opinion in *Perdue v. Wise*:

> [29]As we discussed in *Bates v. State Bridge Commission*, 109 W.Va. 186, 153 S.E. 305 (1930):
>
> When our Constitution of 1872 was formed, the experience of the mother state with debts contracted by her, and with suits to compel payment, were fresh in the minds of the framers of that Constitution. Numerous suits ending in heavy judgments and costs had been prosecuted against the commonwealth; illiberal contracts and guaranties of enterprises had been made by governmental agencies detrimental to her interests; public officers and agencies had not been always zealous and careful in the conduct of public affairs; and juries leaned toward the individual as against the commonwealth. With this experience, the framers of the Constitution of 1872 provided that this state should not contract indebtedness, except in specified instances. . . .

1. Actuarial Assumptions:

From the Supreme Court's *Perdue* opinion:

> There is no dispute that the three funds at issue are currently in actuarially sound condition. While Appellees want us to view the Legislature's obligation to inject increasingly large appropriations into the funds at issue because of the UAAL [unfunded actuarial accrued liabilities] as the type of enforceable debt that translates into a "previous liability" within the meaning of the debt clause exception, we are not persuaded by this argument. To be required to make appropriations is one thing; to have a valid and enforceable debt against the state is an entirely different matter.

The pension plans are "actuarially sound" because sufficient funds exist to pay pension claims. It is the unfunded liability of $5.5 billion that the bonds seek to address. Pension checks are not bouncing now, nor will they be in the foreseeable future.

The actuary uses various assumptions in projecting this $5.5b liability. Some of the assumptions are:

a. project the number of retirees
b. project retirement ages of retirees
c. project retirees' wage bases to calculate benefits
d. project life expectancy of each retiree
e. project rate of return that investments will earn

As one can readily determine, a minor change in any assumption yields significantly different results. Ten actuaries will project ten different numbers in calculating UAAL.

It is important to understand that an actuarial estimate is not an exact figure, such as the cost of a bridge. Therefore, while the voters have approved bonds in the past to build "$500 million of roads", they are not voting to pay $5.5b of actual pension checks with this bond issue. The intent of this bond issue is to borrow money to arbitrage, hoping that the return on investments will reduce future payments to the pension plans.

2. Is $5.5 billion needed?

As an economist, I assert that you are better served to pay off debts with future dollars because inflation makes those dollars cheaper. In this case, the present plan to pay the UAAL over the next 30 years makes sense. Even though the amount balloons to $600 million in 2034, those dollars will be much cheaper because of inflation—even if inflation is only 1% per year.

By borrowing the entire $5.5 billion now, one must realize that we are moving a big part of that future debt closer to the present and, thus, will have to pay the bonds and interest with more expensive dollars.

If one understands the inflation effect, and further understands that inflation will increase at a rate of at least 1% per year (and more likely at a rate of 2%-3%), then one must look at the risk factor of borrowing this money in a different light. In doing nothing, we pay the UAAL (according to current plan) with ever-cheaper dollars. By borrowing $5.5b and investing it in stocks, we must net at least the inflation amount to accomplish the same goal. Is the risk of arbitraging $5.5b and **not** netting the inflation amount worth it?

The other side of this picture would be: If the state was now paying $600 million to the pension plan but would only owe $300 million in 2034, then it would make sense to move today's payments into the future. In such a scenario, the state would adopt level debt service of about $450 million per year. This technique is called "advance refunding" and it is frequently used when current debt service is high and future debt service is low. The rationale of paying debt with cheaper future dollars applies here.

3. Means test

I read an article that quoted a financial advisor as saying that a state should use a figure of 5% of General Revenue as being a good rule of thumb to determine the level of debt service that the state could afford. I recall he also said that West Virginia was somewhere near 3% at present time. This article might have been in the *State Journal*.

Someone with expertise ought to examine this "rule of thumb" and offer an opinion on whether WV can afford debt service on $5.5b.

The rebuttal in this argument will be that the state does not have to pay the full interest rate on the bonds (the coupon rate) because bond proceeds will be invested in stocks and other bonds to earn income. The earned income from investments will offset the coupon interest. Therefore, the actual debt service will be minimal or nothing, and as the rebuttal goes, the "rule of thumb" won't actually apply in this case.

This rebuttal works provided investment income materializes at the level anticipated. If it falls short, the bonds still have to be repaid and then we need to know (in advance) just how much General Revenue is available to pay the interest. This "rule of thumb" calculation will tell us how much risk we can afford if and when investment income sags below coupon interest.

4. General Obligation

If the voters vote to amend the Constitution and authorize this debt, the debt is a general obligation of taxpayers. By definition, and by act of their own hands, the voters are obliging themselves to incur taxes at any level necessary to pay off the debt.

Regardless of talk and promises, do the voters truly understand the bargain they are striking? To make sure they do, I suggest that voters be informed of the scenario of a default.

The voters deserve to know the ramifications of a worst-case scenario—a scenario where they have to repay $5.5 billion in principal plus interest thereon plus a significant loss on investments. What does happen if the state loses a bundle on its investments? What happens if the state has to refinance $7 billion? Or $8 billion?

In a default scenario, both individual taxpayers and corporate taxpayers might flee the state in droves to avoid the huge tax increases that a multibillion-dollar bond default would cause. Businesses that remain might be taxed so highly that layoffs and high unemployment would result. The state's consumer and commercial banking system might be crippled by shrinking deposits and increased loan defaults. There surely would be a moratorium on issuing school bonds, water & sewer bonds, and the like.

If default occurs, it would not be unthinkable to experience a recession and ensuing out-migration similar to the early 1980's when 11% of the population (mostly working-age people) left the state.

Is default a far-fetched scenario?

West Virginians need only look back 50 years in their history to review the WV Turnpike bond default. Though not a general obligation debt of the state, WV Turnpike revenue bonds ($133 million issued) went into default soon after the turnpike opened and remained in that status until 1989. The federal government bailed out the WV Turnpike Commission by agreeing to rebuild the 88-mile highway as Interstate 77. The turnpike was also nationally known for its horrible traffic accident death rate which was satirized by tee-shirts that read, "I survived the WV Turnpike."

The Federal Highway Administration spent over $600 million (which was matched by 10% state funds under the interstate funding formula) to rebuild the turnpike. The original agreement, approved in the 1970's, provided that tolls could remain on the road until the bonds were paid off. A new agreement was approved in 1989 which allowed the tolls to remain on the road even after the bonds were redeemed. Viewed from today's perspective, even after paying hundreds of millions of dollars in toll fees, West Virginians are still paying for the WV Turnpike bond default.

In the late 1980's, the state of West Virginia got caught in an interest rate swing. The state's investment portfolio lost an estimated $300 million. West Virginia was not alone as Merrill Lynch, J. P. Morgan, and other financial traders suffered huge losses.

And then there is this story:

> On December 6 1994, Orange County, a prosperous district in California, declared bankruptcy after suffering losses of around $1.6 billion from a wrong-way bet on interest rates in one of its principal investment pools. The pool was intended to be a conservative but profitable way of managing the county[']s cashflows, and those of 241 associated local government entities. Instead, it triggered the largest financial failure of a local government in US history.
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> Robert Citron, the hitherto widely respected Orange County treasurer who controlled the $7.5 billion pool, had riskily invested the pools funds in a leveraged portfolio of mainly interest-linked securities. His strategy depended on short-term interest rates remaining relatively low when compared with medium-term interest rates. But from February 1994, the Federal Reserve Bank began to raise US interest rates, causing many securities in Orange County[']s investment pool to fall in value.
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> Source: http://www.erisk.com/Learning/CaseStudies/ref_case_orangecounty.asp

5. Why are state worker pensions sacrosanct?

We've seen industry after industry walk away from pension obligations. We've seen case after case where retirees accept a lower pension from the federal Pension Benefit Guaranty Corp. than they were promised by the company.

West Virginia has mismanaged its pension plans the same as have corporations like Bethlehem Steel (once a blue-chip, Dow 30 company). Why is it that West Virginia

feels obligated to pay an obligation that it could never have afforded in the first place? Why can't West Virginia go back to the table and say, "We'll give you 75% of what we promised. Take it or leave it?" Why hasn't this option at least been discussed before coming to the voters for $5.5 billion?

Why do West Virginia state workers deserve to be in a privileged class?

The answer to this question is that state politicians are asking for a bailout. As state politicians are avoiding any responsibility to reduce pension obligations in a time of grave crisis, their inaction then begs the question: "What's to keep them from doing it all over again?"

Another relevant point to think about is that the number of state employees always increases despite promises to shrink government. In going forward, we must assume that government employment will continue to increase—there is no model to predict otherwise. With an increasing number of retirees being paid retirement benefits that we have shown we can't afford now, what will be the likely outcome? As medical science advances, so does life expectancy. Therefore, just how long will it be until the next pension plan crisis befalls the state?

At one point, language in Senate Joint Resolution 101 (2005) contemplated (and addressed) future problems with unfunded liabilities:

> The bond resolution shall further pledge, and the indenture shall so state, that while any of the bonds are outstanding, should any increase of existing benefits or the creation of new benefits under any of the pension systems administered by the State, other than an increase in benefits or new benefits effected by operation of law in effect on the date of ratification of this amendment, cause any additional unfunded actuarial accrued liability in any of the pension systems administered by the State (calculated in an actuarially sound manner) during any fiscal year, such additional unfunded actuarial accrued liability of that pension system will be fully amortized over no more than the five consecutive fiscal years following the date the increase in benefits or new benefits become effective.

Here's what happened: (Lawrence Messina reporting in the 2/24/2005 Charleston *Gazette*)

> During the special session, some retirees expressed concern about Manchin's proposal. They cited language in the resolution that would require any pension benefit increase to be fully-funded within five years -- a difficult deadline even during fiscally flush times.
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> But that language was removed before the resolution was approved, and retiree groups support the bond issue.
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> "If this bond issue doesn't pass, it will be much more difficult to lobby for a benefit increase," said Garry Lynn Shearer, a retired Lewis

County teacher and a member of the West Virginia Association of Retired School Employees.

One does have to ask: Can politicians prudently manage a pension plan?

6. Future legislatures and governors

If the state does borrow $5.5 billion to bail out the pension plans, then there will not be any discussion or negotiation to reduce pension benefits from a practical standpoint. State employees would certainly go on the warpath if the state wanted to reduce pensions after going to the trouble of borrowing a huge sum to secure promised benefits.

This raises a point of concern for future legislatures and governors. Suppose the voters revolt in 2008 or 2012 or 2016 or 2020. Suppose the voters elect a conservative governor and legislature that campaign on the issues of reducing pensions and redeeming the pension bonds earlier than planned. Could that governor or legislature really change anything? What we do in 2005 will lock in future legislatures and governors for the next 20-30 years. So this is not a decision to take lightly. Nor should this bond issue be viewed solely from the standpoint that it just addresses past problems because it creates future problems of pension administration as well.

7. Just what is the state's legal obligation as to pensions?

This is one for the lawyers. As I read the *Perdue* decision, the Supreme Court says that pensions are a debt of the state. However, I also read that pensions are a debt **because** they are promised by statute.

It does not appear to me that the court is declaring that the existing pension plan is a debt that is carved in stone. As I read it, the legislature is free to change the statute and, thus, pension benefits.

I'd like to see the lawyers debate the constitutional and legal ramifications regarding all of the options—from borrowing the money to reducing benefits.

8. Size of bond issue; underwriting costs.

In *Perdue v. Wise*, the court offers its opinion on the Pension Liability Redemption Act (2002) that approved the sale of $3.9 billion of pension bonds and the opinion includes this footnote:

> Before any proceeds can be realized however, an initial $39 million, or 1% of the bond amount issuance, is permitted under the Act to be charged as costs for purposes of paying the underwriters, brokers, bankers, and lawyers who prepared and marketed the bonds. *See* W.Va. Code § 12-8-4(c). Appellants represent that other costs will consume another $24 million before the remaining proceeds can be credited to one or more of the three public retirement systems. The interest payments on the bonds over their term is calculated at $2 billion dollars.

Senate Joint Resolution 101 (passed in January) authorizes the sale of $5.5 billion of bonds and the paying of **any costs** of issuance. How did we get from $3.9 billion with a 1% restriction on underwriting fees to $5.5 billion with no restrictions on underwriting fees?

9. Investment performance

Selected stock funds performance since inception:

T. Rowe Price Balanced Fund	10.08 %	annual return since 1939
Vanguard Windsor Fund	12.53%	annual return since 1958

Selected bond funds performance since inception:

Vanguard LT Investment Grade	9.21%	annual return since 1973
T. Rowe Price New Income	8.19%	annual return since 1973

Benchmarks:

Vanguard 500 Index Fund	12.25%	since 1976
(this fund mimics the S&P 500 index)		
Lehman Brothers Aggregate Bond Index	7.72%	since inception

Selected stock & bond fund performance since inception:

Vanguard Wellington Fund	8.34%	annual return since 1929

The WV Investment Management Board cannot invest more than 60% of its funds in stocks. Using a blend of the above historical stock fund and bond fund yield information might indicate future returns over the 30-year term of the bonds.

In the seven years that the state's Investment Management Board (IMB) has been allowed to invest in stocks, press reports say that years 1-3 were positive, years 4-6 were negative, and year 7 (2004) was positive. Overall, it was reported that the average annual rate of return was 5.5%. Press reports indicate that West Virginia has one of the best-performing IMB's in the nation.

Keep in mind that selling pension bonds was the brainstorm of the Underwood administration and that the plan was hatched when the stock market was returning 15% per year or more. This was the stock market that Chairman Greenspan called "irrational

exuberance." It is highly doubtful that we will soon see the returns that the market paid in 1997, 1998 and 1999.

Had the Underwood administration been allowed to sell pension bonds, those bonds would have carried an interest rate of at least 5.5%. That's the same rate that West Virginia general obligation road bonds carried about that same time.

Say what you will about investments earning 8%-12% per year over the long term. Here's the reality of recent history: Had WV done in 1997/98 what it proposes to do in 2005, the state would have only broken even. There would have been no investment earnings to reduce the UAAL (unfunded liability). There might have even been a small loss (had the bonds sold at an interest rate higher than 5.5%.)

The voters need to understand that investment markets cannot be predicted—every money manager in America lost money on MCI, including (as I recall) West Virginia's IMB. Nobody predicted 9-11 either. And nobody alive now can predict what North Korea will do. Nor can anyone predict Wal-Mart's sales for Christmas season 2011.

The odds are favorable that West Virginia's IMB can make money from investing the bond proceeds. The question is: Can WV afford to play the odds?

10. How much will the bonds cost?

The voters are being asked to approve the sale of bonds but the cost of the bonds won't be known until they are marketed—buying a pig in a poke, so to speak. While some individual investors will buy WV pension bonds, the likeliest buyers are large institutional investors. It is impossible to tell at this point just what kind of an interest rate these buyers will demand. People aren't going to be tripping over each other to buy these bonds. Thus, a "clique" of money managers, perhaps even lenders of the last resort, will dictate the interest rate.

Other cost issues are the covenants—the guarantees that the state must make to satisfy investors that the pension bonds will be paid off. Who knows exactly what covenants the buyers will demand? Will they handcuff the entire budget process for 30 years in order to be first in line at the pay window? Will state forests be secured as collateral?

The cost of the bonds will be critical because the closer it gets to 8% the less chance there is that the purpose of the bonds can hold up. The state's IMB needs to make at least 2% more from investments than the state pays out in bond interest for this plan to be worthwhile.

While not a cost, this is a concern. The voters need to understand that the term "institutional investors" includes foreign banks, foreign financial firms, and foreign

governments. Will the voters be comfortable with the Bank of Japan or the Saudi royal family owning $4 billion of the mortgage on their house?

The unfortunate aspect of this area is that once the voters approve the sale of bonds, the terms and conditions will be negotiated and approved almost exclusively by the governor's office. The governor will make the decisions on paying the interest rate and agreeing to the covenants (provided, of course, that covenant restrictions don't require additional legislation.) If the voters approve the bond issue on June 25th, what happens after that is completely out of their control but they will have to abide by the consequences.

Do the voters trust the sitting governor, or a future unknown governor, to the extent that they will allow him sole signature authority to borrow $5.5 billion?

11. Refinancing?

Gov. Wise and the previous legislature pursued the sale of pension bonds on the basis that the UAAL was a "previous liability" of the state; hence, a refinancing and not a borrowing of new money. The Supreme Court in *Perdue* declared that the UAAL was not a previous liability. (See quote in item #1)

Nobody should be allowed to try and convince the voters that this bond issue is a refinancing even though we have heard the comparison tossed around loosely since the Court issued its ruling.

West Virginia is borrowing $5.5 billion to play the stock market.

12. Where is Larry Harless now that we really need him to ask tough questions?

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