"Rebuild America Bonds" and Public Pensions: One Size May Not Fit All

Rep. John Yarmuth's (D-Ky.) new plan to use "Rebuild America Bonds" to simultaneously address shortfalls in U.S. infrastructure investment and offer the opportunity for pension funds to increase their risk-adjusted returns represents an approach that could have very different credit impacts on individual municipal bond issuers, depending on their pension plan's current funding status, retiree demographics, and cash-flow needs. Issuers with relatively well-funded plans would be in the best position to benefit, while others may be unable to participate at all.

According to preliminary reports (Rep. Yarmuth plans to introduce formal legislation later this month), the Federal government would sell $300 billion of the new RABs to pension plans and use the proceeds to capitalize a National Infrastructure Development Bank. The bonds would yield 200 basis points above 30-year Treasury yields and would have to be held for a minimum of 10 years.

National Infrastructure Bank proposals have been around for some time, and their effectiveness has been debated, but the implications of Rebuild America Bonds for public sector pension plans deserve further consideration.

At BAM, part of our analysis of pension risk when we consider insuring a bond takes into account the riskiness of the pension assets. To the extent an investment in the RABs would lower the overall risk profile of the pension assets without a material decline in expected return, dedicating a portion of the portfolio to these bonds would generally be a positive factor in our evaluation of pension risk. That review would also take into account whether the fund adjusted the assumed rate of return on its investments following the purchase of RABs, as well as the impact of any assumption changes it made.

Even though the RABs would have to be held at least 10 years, they would still be paying the above-market yield while they are held. This means that a very dependable, predictable stream of cash flows can be created as part of a risk-reduction strategy to match the bonds' cash flows with a stream of benefit payments to retirees. Such an approach could, again, lower the pension fund's overall risk profile and be viewed favorably in our analysis.

However, RABs may not be the best fit for pension funds that are forecasting the need to liquidate assets in order to meet their pension payments within the 10-year timeframe – including funds with a high unfunded liability and a high proportion of retirees to active employees. If those plans are required to hold their Rebuild America Bonds through that period, they might be forced to sell other, more volatile assets to raise cash, raising the risk that they may realize a loss, depending on market conditions at the time of sale.

In summary, while the option to invest in higher-yielding risk-free securities could improve the average risk profile of public pension funds nationwide, it would not be a universal benefit. BAM would continue to take a granular approach and view holdings of Rebuild America Bonds in the context of an individual plan's investment risk and liquidity needs when evaluating their impact on an issuer's overall pension risk.

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