



Public Pension Woes Make Differentiated Muni Investing Key

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EXECUTIVE SUMMARY

As public pension funding gaps and municipal fiscal challenges continue to make headlines, Standish senior analyst Mark Stockwell reminds investors that it is more important than ever to take a differentiated view of the municipal bond market and understand which sectors are likely to be affected and how. The potential impact from rising pension costs will not be uniform across the market, and about 65% of the market should see little or no impact from pensions. Revenue bond sectors such as public power, toll roads, and water and sewer have limited amounts of labor-related expenditures, which reduces their pension exposure. The greatest impact from pensions will be on state and local governments, which represent only about 35% of the municipal bond market. Although public pension funding levels are recovering from their recession lows, landmark bankruptcy cases and ongoing fiscal concerns are keeping the spotlight on pension reform and the potential effects on state and local bonds. Standish believes that most state general obligation (G.O.) and unlimited tax local G.O. bonds should withstand pressure from pension liabilities; whereas local appropriations debt, limited tax local G.O.s at their tax rate limit and state G.O. credits with weak pension liability management could be most vulnerable. While the pension funding issue is serious and might reduce the amount of revenues available to pay debt service on municipal bonds, Standish does not believe it will lead to widespread insolvency and defaults in the municipal market. Deep municipal bond credit expertise will continue to be key for staying on top of shifting risks and opportunities.

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PUBLIC PENSION CHALLENGES

Buffeted by constrained public finances, financial market volatility and government policy decisions, pension burdens for state and local governments have grown by several measures. The Center for Retirement Research at Boston College (CRR) reports that the FY 2013 funding ratios of state and local public pension plans had declined to 72% from their pre-recession peak of 87% in 2007. Fitch estimates that the unfunded liabilities of state pension plans as a percentage of personal income now exceed the level of state bonded indebtedness: pension liabilities have reached 3.3% of personal income while net debt is at 2.6%.¹ As with states, local governments have also been impacted by growing pension liabilities. Wilshire Consulting reports that local government pension funding ratios had peaked at 90% prior to the recession, but by FY 2012, funding ratios had dropped to 69%.²

As pension funding ratios decline, state and local authorities face increased costs of funding pension liabilities. The CRR reported that the average annual cost to fully fund local pensions was 7.1% of annual operating revenues. There is a wide variability in the burden of pension costs on cities, and those with pension costs in the top quintile have an average pension cost at 12.3% of revenues, according to CRR.

The impact from pensions on a state or local government depends on the level of pension liabilities and the fiscal flexibility officials have to respond to the liabilities. While funds used for state general obligation bond debt service and for public pension contributions are typically from the same source, most states have the resources to respond to the variability of pension fund liabilities and the need to increase annual pension contributions. The fiscal flexibility of local governments varies more widely, based not only on credit quality, but also on the type of revenues pledged to pay debt service as well as the state statutes governing the terms of the pledge. Local general obligation bonds are typically funded by dedicated property taxes and have stronger bondholder protections than local appropriation bonds, which have greater vulnerability to increased pension costs. Local appropriation bonds generally lack a dedicated funding source, and may directly compete with pension expenditures for limited resources, particularly when tax revenues decline.

MARKETS, POLICY & LONGEVITY HELP DIG PENSION HOLE

Market volatility, policy decisions and longer life spans have driven the increase in pension plan liabilities and fluctuations in funding levels. The biggest shock to plan assets came in 2008 with the 37% drop in the S&P 500. That year, state and local government pension plan assets fell by over 26%, and in FY 2009 state pension plan funding levels fell to 77%, after reaching 86% in FY 2007. Funding levels were falling at the same time the Great Recession was making it harder for state and local governments to make ends meet.

The Annual Required Contribution (ARC) is a key component for pension plan solvency. Annual contributions below the ARC are a sign of potential financial problems, particularly when the ARC has not been met for a number of years. The precipitous decline in pension plan assets during the financial crisis had a significant impact on the level of ARCs. According to the CRR, the cumulative ARC in 2008 was 12.5% of payrolls, but by FY 2013, the ARC had increased to 17.6% of payroll even as tax revenues

¹ "The Funding of State and Local Pensions: 2013-2017," Center for Retirement Research at Boston College, June 2014; "Pension Pressures Continue," Fitch Ratings, 2014 State Pension Update, May 14, 2014.

² Wilshire Consulting's 2014 Report on City & Country Retirement Systems: Funding Levels and Asset Allocation, August 26, 2014.

were falling because of the recession. To balance the budget, more state and local governments cut their pension contributions to levels below the ARC. The CRR reported that plan sponsors paid only 81% of the ARC in FY 2012, down from 93% in FY 2008, when ARCs were at a lower level.

ARCs continue to increase because of longer life spans of participants. The municipal workforce has grown and as it ages the ratio of active employees to retirees has fallen. Moody's reports that the ratio is over 50% in Michigan, and CalPERS is projecting that retirees will outnumber active employees in a few years.

Policy moves have also increased pension liabilities, such as the automatic cost of living adjustments (COLAs) added in the 1960s and 1970s to shield retirees from inflation. About 75% of state pension plans have some type of COLA provisions. While some plans have COLAs indexed to CPI, some have fixed guarantees as high as 3.5% annually, meaning pension obligations growth could outpace inflation. Depending on the rate, COLAs can increase plan expenditures by 20% or more.

Policymakers also used the run-up in equity markets in the 1990s as a way to increase pension benefits, as plan allocations to equities increased. Pension benefits were added, with the expectation that equity markets would continue to rise and offset the cost of increased benefits. While that calculation burst along with the equity bubble, pension costs have continued to increase because of those more generous benefit promises.

STABILIZING THE PATIENT, BUT LASTING CURE NEEDED

As the economy and markets have recovered, public pension funding has stabilized. The Federal Reserve Board reports that state and local government pension plan assets hit their highest level in 2014, growing by 9.6% between Q2 of 2013 and Q2 of 2014 and nearly 47% since 2008.³ Nonetheless, many state and local governments still need to take steps to reduce their future liabilities.

While plan assets are now higher than their pre-recession peak, thanks to recovering equity markets, pension funding ratios have only grown slightly, from 69% in 2012 to 72% in 2013 — still below the 87% peak level reported in 2008. Funding levels do not yet reflect the full impact of market gains because most plans smooth out gains and losses over a five-year period. We expect that FY 2014 funding levels will benefit from the rolling off of FY 2009 losses, which will be replaced by FY 2014 gains, including a nearly 25% increase in the S&P 500 at the close of the fiscal year. Contributions from state and local sponsors are also improving. ARC payment levels have improved from 81% in FY 2012 to 83% in FY 2013 and will likely move higher as tax revenues and reserves continue to improve.

Those are positive signs, but a growing number of plan sponsors are looking to control cost growth further to secure the long-term viability of public pensions. Since 2009, 45 states and many municipalities have made some type of reform to their public pension plans include cutting core benefits, modifying or eliminating COLAs, increasing employee contributions, and replacing defined benefit plans with defined contribution or hybrid plans.

Whereas many experts say adjusting benefits for current employees is needed to meaningfully control costs, most of the cost-cutting measures have so far been aimed at pension benefits for new employees. That's because courts have generally ruled that current public employees have a right to benefits already accrued as well as future benefits they are eligible to earn prospectively.

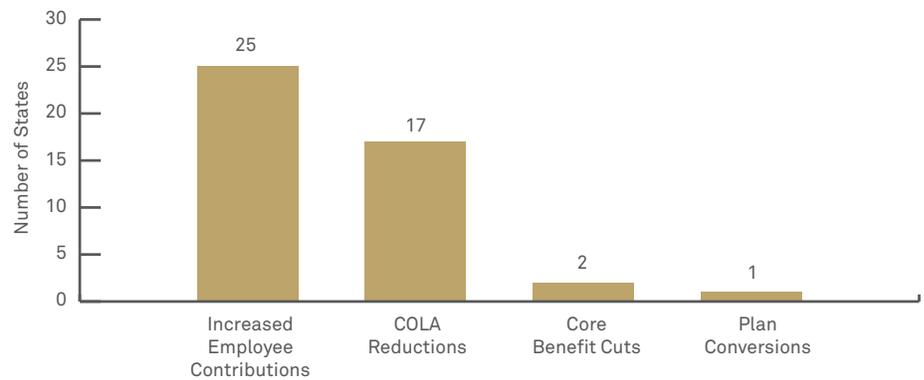
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³ Federal Reserve Board, Financial Accounts of the United States, Flow of Funds, Balance Sheets and Integrated Macroeconomic Accounts, Third Quarter 2014 and Second Quarter 2013.

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The courts, however, do seem to be more open to changing non-core benefits like COLA increases. Our research shows that despite a tendency to protect current employee benefits, some states have nonetheless modified provisions for current employees, especially when it comes to non-core benefits (Figure 1). COLAs for current employees have been reduced or suspended in 17 states, and state courts have upheld all 12 reductions that were challenged in the courts. Based on CRR estimates, we calculate that eliminating a 2% COLA reduces pension benefits by approximately 16 percent and by 23 percent for a 3% COLA.⁴ We estimate that 25 states have increased pension contributions required by current employees. That move was overturned in two states, upheld in one, and is pending court decisions in several other states. Rhode Island replaced its existing defined benefit plan with a hybrid plan for current employees, though that move is now being challenged in the courts.

Figure 1: Summary of State Pension Reforms for Current Employees



Source: Standish

MUNICIPAL BANKRUPTCIES FORCING HARD CHOICES

Meanwhile, recent landmark municipal bankruptcies have forced a wider discussion around the immutability of pension benefits across the board. Recent cases in California and Detroit have shown the willingness of both municipalities and bankruptcy judges to change core benefits for municipalities under bankruptcy protection.

The city of Vallejo in northern California set a precedent when it included rising labor and pension costs in its 2008 bankruptcy filing and the bankruptcy court dissolved one of its labor contracts. Vallejo was able to restructure other labor contracts but chose to avoid a legal battle with CalPERS, acting as trustee for local pension plans, over including pension cuts as well. However, the renegotiated labor contracts lowering salaries imply that the pension payments based on them will also be lower.

The California city's workout plan also highlights the important distinctions across municipal debt sectors and the protections for municipal bond holders. Vallejo has no general obligation debt, but has local appropriation debt with debt service payments guaranteed by bond insurers, who were impaired by the bankruptcy as unsecured creditors. While the bankruptcy plan includes some deferral of debt service payments, we expect that the bond insurers will recover 100%. However, as bankruptcy statutes treat enterprise revenues as special revenues, bonds backed by water and sewer revenues were not impaired by the bankruptcy.

4. "COLA Cuts in State/Local Pensions," Center for Retirement Research at Boston College, May 2014.

Similar to Vallejo, the bankruptcy of Stockton, CA, led to the impairment of holders and insurers of the city's unsecured local appropriation debt, existing labor contracts and cuts to other benefits for current workers and retirees. Although Stockton's approved bankruptcy plan does not impair the pensions of current workers, observers were shocked when the bankruptcy judge said that Stockton could have impaired its pension contract with CalPERS had it chosen to do so.

Detroit clearly intended to include pensions of current employees and retirees and secured bondholders as well as unsecured creditors when it filed for bankruptcy protection in 2013. In approving Detroit's petition, the bankruptcy judge indicated that pensions could be cut in the city's financial reorganization. Similar to the bankruptcy court opinion in Stockton, the Detroit judge ruled that public pensions in Michigan are contracts that can be impaired in bankruptcy.

As part of Detroit's bankruptcy settlement, both current and retired city workers agreed to pension cuts. While benefit payments to public safety employees would not be cut, payments to general employees will be cut by 4.5%. In addition, COLAs for public safety employees will be reduced by 50%, and COLAs for general employees will be eliminated altogether. In the settlement, G.O. Unlimited Tax bondholders will receive 74% of the par amount of bonds while G.O. Limited Tax bondholders will receive 34%. While Detroit did restructure its water enterprise debt, bondholders were not impaired.

The California and Detroit cases have led to speculation that other public plan sponsors might use Chapter 9 to force reductions in their pension costs, but we believe the bar is too high for this to become more widespread. States are not authorized to file bankruptcy, and local governments may file only if authorized by state law. Furthermore, a local government must be financially insolvent in order to receive bankruptcy protection. While rising pension liabilities can be a cause of insolvency, low pension funding ratios or growing pension expenditures do not necessarily mean the local government is insolvent. In addition, legal fees related to bankruptcy can be significant, and bankruptcy can impact a community's reputation, exacerbating existing financial problems.

WIDER INSOLVENCIES UNLIKELY, CONTINUED PENSION REFORM MOST LIKELY

We expect that most state and local governments will be able to effectively manage their pension liabilities. We think the headlines around extreme cases as well as the new GASB regulations requiring more transparency around public pension fund liabilities have, in a positive way, focused officials' attention on addressing pension benefit and funding reforms. Rating agencies will encourage them to continue to do so, rewarding those who do and invoking penalties on those who don't. Illinois and New Jersey have already been downgraded over failure to implement pension reforms. After decades with severely underfunded pensions, the rating agencies downgraded Puerto Rico to non-investment grade levels. Most municipalities will likely continue to increase their effort to reduce pension liabilities to avoid the increased cost of accessing capital markets due to negative ratings actions.

In our view, most high-grade state and local governments should be able to withstand potential pressure from pension liabilities due to their strong credit characteristics and fiscal flexibility. Conversely, low-grade credits do not have the resources or fiscal flexibility to adequately address adverse credit events. Those municipalities without that financial cushion will be more sensitive to the impact of pension liabilities, and growing pension underfunding may be just one symptom of a larger fiscal problem. A state or local government may have long standing budget problems long before it fails to make a crucial increase to its pension contributions.

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The public pension funding challenge is serious and will require long-term efforts by multiple stakeholders to resolve. However, we believe there are still attractive opportunities for tax-sensitive investors to invest in certain sectors of the municipal bond market (Figure 2). Now more than ever, specialized credit expertise is required to manage the risks and opportunities across this differentiated market.

Figure 2: Credits Least and Most Affected by Pension Issues

Credits Least Affected
Enterprise Revenue Bond Sectors: Personnel costs, including pensions, are typically a relatively small portion of the operating expenses for enterprise revenue sectors such as airports, public power, and water and sewer. As such, pensions should have minimal impact on most revenue bonds.
Special Tax Sector: Special tax bonds are typically backed by dedicated tax streams that are protected from operational liabilities, general fund budgets as well as pension obligations. Special tax bonds can provide defensive investment opportunities.
State G.O. Sector: Most states have more fiscal flexibility than other tax-backed credits to address growing liabilities. While pensions may continue to provide pressure to state finances, most states should be able to effectively manage their pension liabilities. The exception to that would be weaker state G.O. sector credits with weak pension liability management (see below)
Unlimited Tax Local G.O. Bonds: Unlimited Tax G.O. tax pledges provide fiscal flexibility and can offset the impact of valuations fluctuations in the tax base. Even in states where the pledge provisions are weaker, the unlimited tax pledge still appears to contain legal protections not provided by other types of pledges. The mechanics of the unlimited tax pledge can also provide cash flow protection from growing pension liabilities.
Credits Most Affected
Weaker State G.O. Sector Credits with Weak Pension Liability Management: While most states have strong credit characteristics and fiscal flexibility, there are a few outliers which by any measure have had significant loss of fiscal flexibility due to growing pension liabilities. Puerto Rico is the most obvious given its underperforming economy, poor fiscal performance and inability to contain its growing pension liabilities. While Connecticut, Illinois, and New Jersey have stronger underlying economies, they have failed to implement pension reforms or planned pension contribution increases.
Limited Tax Local G.O. at their Tax Rate Limit: The limited tax structure may not provide the mechanism to fully offset tax base fluctuations nor provide effective cash flow protection from pensions. The level of protection will depend on the cushion between actual levies or rates and legal limits. Our concern is for those local governments at or near their legal rate limit as debt service may be more dependent on general fund resources and in effect competing for resources with pension liabilities.
Local Appropriation Debt: We expect local appropriation debt to continue to be most vulnerable to pension liabilities because debt service is typically funded from the general fund, the same source used to pay pension contributions. As a result, debt service is in direct competition with pension contributions, generally from a source that has no specified revenue pledge. Within the sector, we are most concerned with local appropriation debt issued by California cities and counties. The fiscal structure for California cities and counties is weak and provides almost no fiscal flexibility during economic and financial downturns or during fiscal emergencies.

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