

The Accelerating State and Local Pension Crisis

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EXECUTIVE SUMMARY

Traditional municipal credit analysis has long included a review of a municipal issuer's pension system, focusing on the unfunded liability (that is, the value by which accrued pension liabilities exceed the pension plans' assets) which could be considered a future debt burden. Additionally, the issuer's annual payment to the pension plan(s) is reviewed as part of the cyclical budget process.

However, in recent years the focus on pension plan underfunding has grown, particularly following the Great Recession and the burden of making annual contributions as municipal budgets came under stress. The existence of a large unfunded liability and the annual contribution payment by the municipality have become increasingly important drivers of a municipal bond issuer's rating and, in extreme cases, its ongoing fiscal viability.

The existence of an underfunded and growing pension liability has been a key determinant in the downgrading of general obligation bond ratings in the cases of Connecticut, Illinois, Kentucky, Louisiana and New Jersey. Multiple downgrades from the major rating agencies have left the State of Illinois with ratings on the brink of falling to below investment grade.

The health of a pension fund is often assessed by examining the funded ratio, or the valuation of a plan's assets to its total accrued liabilities. There are

various ways to calculate this figure, but recently pension experts have preferred to use a discount rate well below that used by most state plan administrators. While the plans themselves may have assumed a 6%, 7% or even 8% annual rate of return on investments, a much more conservative approach is to use a lower expected return. For example, the American Legislative Exchange Council (ALEC), a non-profit research organization of state legislatures, has calculated the funded ratio using a 2.34% discount rate, a "risk-free" rate extrapolated from U.S. Treasury bond yields of varying maturities. This highly cautious approach has revealed **that no single state has achieved a fully funded level, with the highest level calculated being Wisconsin's 63.4%**. Although this approach is highly conservative, it does emphasize the need for many states to increase the annual contribution and/or adopt reforms of some type.

Regardless of how the ratio is calculated, the states with the most highly funded

plan(s) are consistently Wisconsin, North Carolina, South Dakota, Tennessee, Idaho and New York. Conversely, states which chronically appear on lists of the worst funded plan(s) are Michigan, New Jersey, Illinois, Kentucky and Connecticut.

THE LOCAL PENSION SITUATION

While states may experience the penalty of a rating downgrade, more serious implications exist for a local issuer with unwieldy pension obligations. Faced with finite tax resources and a variety of growing public-purpose expenditures competing for taxpayer dollars, pension contributions among them, a municipality could ultimately resort to default or even Chapter 9 bankruptcy, if allowed by law.

Pension payments were among the precipitating factors in a number of fairly recent Chapter 9 filings by municipalities, including the cities of Vallejo and San Bernardino and, in the most dramatic example, the City of Detroit. The City of Chicago and the Chicago Public School System are also examples of issuers plagued by multiple bond-rating downgrades, driven in large part by pension system burdens.

The alarming deterioration of the City of Dallas Police and Fire Pension Fund has also intensified the focus on public pension funds and the credit ramifications. This Dallas fund has suffered asset devaluations which, combined with the loss of assets due to lump-sum retiree withdrawals, has left the plan severely underfunded. The Texas state legislature is finalizing a number of reforms to rescue the fund, but Dallas' general obligation bond rating has suffered due to this development amid uncertainty as to the city's taxpayer-funded support of the collapsing plan. Furthermore, the mayor at one time alarmingly used the word "bankruptcy" as a possible outcome for the city, were plan reforms not instituted.

THE FUTURE OF STATE PENSION FUNDS AND REFORMS

Many states have already implemented measures to decelerate the growing pension fund gaps. However, these primarily involve benefits for new employees, such as increasing the vested retirement age, requiring some level of employee contributions or shifting to a form of defined contribution plan. Current

workers and/or retirees may face changes in the form of revisions to the Cost-of-Living Adjustment (COLA).

Changes to benefits paid to current workers are extremely difficult to make politically and may be faced with legal challenges. Alternatively, a plan's managers could pursue more aggressive non-traditional investment options for higher potential returns. However, these options also include more risk; a contributing factor to the Dallas pension fund calamity was an investment portfolio heavily weighted in real estate.

Ultimately, states are likely to be burdened with large and ballooning annual pension contributions, leading to difficult spending choices among public programs and the potential for additional rating reductions.

As such, careful and well-researched credit selection remains crucial. We believe certain state general obligation bonds, essential service revenue bonds issued by water, sewer and electric enterprises, select local credits with strong financial positions and stable tax bases, and various health care and education issuers will remain securities with minimal credit risk.

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