Municipal Bonds—When Full Faith and Credit Falls Flat

PERSPECTIVE FROM OUR MUNICIPAL BOND TEAM

Once upon a time, US municipal bonds were generally considered less risky than corporate bonds. Backed by the full faith and credit of state governments, investors had confidence they would receive their principal plus interest without fail. Times have changed. For some states and local governments, decades of financial mismanagement and massive pension liabilities are threatening to upend the full faith and credit pledge.

In this article, we explain why we don’t invest in uninsured general obligation bonds from the state of Illinois and the city of Chicago. As municipal bond analysts, assessing pension risks hinges partly on the willingness of elected officials to implement tangible pension reforms. Absent that, large pension obligations can significantly degrade budgets, credit quality and eventually impair bondholders. Here’s the good news: after excluding some local bond exposures, like Chicago’s, that still leaves well over 85% of the general municipal market available for investment. In some instances, we think essential-service revenue bonds offer more stability than general obligation bonds.

A global challenge that feels very local

If there’s one issue where frictions between budget reforms and politics burn brightest, it’s pensions. With the proportion of retired pensioners and lifespans increasing across the globe, many governments face a challenging dilemma: how to raise enough tax revenues from the young to pay for the pensions promised to the retired? It’s a vexing issue that impacts our firm’s sovereign bond research as much as it does our municipal bond analysis.

Consider Brazil, for example. Pension liabilities currently absorb a third of Brazil’s federal tax receipts and fuels chronic deficits. Transitioning to a sustainable glidepath means Brazil’s new president, Jair Bolsonaro, must pass sweeping reforms that require changing Brazil’s constitution. Even if the reforms make it through congress this year, there’s nothing stopping a future president from reversing them. Case in point: Italy. After passing reforms in 2011—increasing the retirement age to 67, shifting more workers to defined contribution schemes, and stopping inflation indexing of pensions above a certain income level—Italians elected a new government in 2018 that promised to overturn them.

In the US, unfunded pension liabilities loom particularly large at the state and local level, making them a key focus for our municipal analysis. The scale of the liabilities is unnerving. In August of last year, Moody’s reported that adjusted net pension liabilities across US states spiked to US$1.6 trillion in fiscal 2017—increasing 25.5% from the prior year and representing 147.4% of state revenues. When Moody’s and the US Federal Reserve add up unfunded pension liabilities across state and local US governments they total around US$4 trillion, as shown in Exhibit 1 on the next page.

Bankruptcy still taboo?

Pension liabilities didn’t rattle US municipal bond markets much before the financial crisis. General obligation bonds, after all, are senior in the capital structure and backed by the full faith and credit of state and local governments. Even when major cities faced insolvency—New York City in the 1970s, Cleveland in the 1980s, and Philadelphia in the 1990s—filing for bankruptcy and impairing bondholders was taboo. In these three cases, each city’s state stepped in to ensure all obligations were paid; either by creating a financial bail-out vehicle or by installing a state-controlled board to oversee local finances.

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The situation is indeed dire. The city's four
common mathematical ability to pay debts. Whether a city or state is able to pay their debts (we do the math),
their debt, renegotiate union contracts and reform pensions.

Bankruptcies and defaults are still rare overall, thankfully. In today's political climate, however, we've seen cities and policy
advocacy groups threaten bankruptcy to wring more funding
from state governments; or utilize bankruptcy filings to restructure
debt, renegotiate union contracts and reform pensions. As municipal bond analysts, our main question now is not just
whether a city or state is able to pay their debts (we do the math),
but this: are politicians willing to impair bondholders in order
to honor their predecessor's pledge to pensioners? Willingness to
enact meaningful pension reforms is harder to analyze than the
mathematical ability to pay debts.

Unfunded US Pension Liabilities

Exhibit 1: Moody's and the Fed peg liabilities at around US$4 trillion
Annual 2017 values (Fed), 12-months ending September 30, 2017 (Moody's and GASB)

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Fed | Moody's | GASP |
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| Total liabilities | Assets | Unfunded liabilities |
(i.e., difference between total liabilities & assets)

About discount rates
US state and local governments discount their pension liabilities with equity-like returns under Governmental Accounting Standard Board (GASB) rules. In this chart the average discount rate under GASB is 7.3%, representing a sample of 179 pension plans. Moody's and the Fed use corporate bond returns to discount liabilities—Aaa for the Fed, and an Aa corporate bond index (3.9%) for Moody's.

Sources: Moody's Investors Service, Board of Governors of the Federal Reserve System.

That practice changed after the financial crisis. For cities like Chicago, decades of chronic pension underfunding and
unsustainable benefit enhancements had grown silently into giant
and toxic pension liabilities. Faced with unescapable budget shortfalls—set in motion by long-retired predecessors—several
cities filed for bankruptcy, including Detroit, Michigan in 2013. In some cases, pensioners received preferential treatment over
bondholders. Most Detroit bondholders, for example, eventually recovered US$14–74 cents on the dollar after the bankruptcy, whereas pensioners recovered US$95 cents. The new reality is this: pension obligations may hold a senior position to a bond's full
faith and credit pledge.

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Chicago's pension beast
Consider Chicago, Illinois—a town where politicians are so full of hot air, the city earned the nickname “the windy city” around 1890. In 2015, Chicago became the only major metropolitan US
city outside Detroit to receive a junk rating from the Moody's bond rating agency, largely because of its escalating pension bills.
Chicago's then-mayor Rahm Emanuel promptly fired Moody's from rating the city's new bond issues and castigated them in the
press. The mayor publicly attacked Moody's again in 2017
during a run-up to a $1.2 billion bond sale, over frustrations his
city had to pay higher interest rates.4

We're interested to see how Chicago's new mayor, Lori Lightfoot,
responds to rating agencies like Standard & Poor's—particularly
if they drop Chicago below investment grade because of pension
challenges as Moody's did. Lightfoot spoke bluntly about the
City's pension dilemma during her campaign: “the pension beast is
going to consume virtually everything that we do if we do not get a handle on it.”5 The situation is indeed dire. The city's four
pensions are about US$28 billion short of being fully funded.
By state law, Chicago must produce an additional US$1 billion in revenues annually starting in 2023 to feed the beast—an
enormous increase for an already strained budget. It's also a
heavy burden for a tax base of Illinois voters already reeling from
(and moving away from) recent Chicago property tax increases
to pay for these pensions.

All eyes will be on Lightfoot as she soon heads into contract
negotiations with Chicago's police and fire unions—a red hot
potato mayor Emanuel punted to his successor. Since the
contracts lapsed in 2017, the new terms may include tens of
millions of dollars in retroactive pay increases. Standard & Poor's
is on record stating if those new salaries increase Chicago's
budget gap and further escalate pension costs, it “could change
our view” of Chicago's credit quality.6

State constitutions
Chicago proves just how challenging large pension liabilities can
be. The risks, however, vary significantly across the US. Since
the financial crisis, 74% of state pensions and 57% of local
government plans have taken positive actions by either reducing
pension benefits and/or increasing contributions.7 A common
reform involves reducing cost-of-living adjustments (COLA), which
shrinks future liabilities and frees up money to service debt
obligations. The Colorado state legislature, for example, capped
COLAs at 1.5% last year, and increased state and employee
pension contributions.

Cutting pension benefits is dicey for politicians who fear voter
backlash. It’s especially challenging for states that legally shield
their pensions from reforms. Illinois' state constitution, for
example, says existing pension benefits "shall not be diminished
or impaired"—effectively ruling out solutions like COLA.
adjustments unless the legislature amends the constitution. That presents Illinois’ governor with a big challenge: absent amending the constitution to reduce pension benefits, the governor must raise substantial new revenues in order to feed the US$250 billion of unfunded pension liabilities (the largest of any US state).

Let’s look at this shortfall in the context of other US states. Illinois currently spends a little under 20% of its budget on pensions, according to Moody’s. When you add in expenditures on healthcare, other post-employment benefits and debt service, fixed costs gobble up just under half of annual outlays in Illinois and states like Connecticut, as shown in Exhibit 2. With high fixed costs, these states have less flexibility to service their debts, especially if tax revenues shrink because the economy cools, or if their tax base moves to another state. We think it’s worth noting this chart doesn’t fully capture the size of Illinois’ pension predicament, since Illinois’s budgeted pension payments don’t come close to tackling its full pension liabilities.

**Drowning in liabilities**

The bond market is aware of pension shortfalls in states like Illinois (US$250 billion), Connecticut (US$71 billion) and New Jersey ($116 billion), and prices in that risk through higher spreads. Our analysis shows Illinois’ bondholders (and Chicago bond holders, for that matter) are in a uniquely dangerous situation the market isn’t fully pricing.

**Large Fixed Costs = Less Flexibility**

The size of the new tax revenue (still years off) is unclear, and voter approval remains uncertain. As for pushing payments further into the future, that simply repeats Illinois’ all too familiar pattern of putting off hard choices while eroding pension funding. Illinois bond ratings are already skating just one notch above “junk” status. If Illinois gets downgraded, the pain could be sharp.
The Illinois exodus
In our view, the writing on the wall lies with Illinois’ collapsing population. According to the US census bureau, Illinois saw the second biggest drop in residents in 2018 after New York, losing 45,116 residents. Since 2013, over half a million Illinois residents have left the state seeking lower taxes, nicer weather and better economic opportunities across the US. From a revenue perspective, many of the people leaving are of working age while the population left behind is aging, according to the Northern Illinois University’s Center for Governmental Studies.

Chicago’s taxpayers face an especially onerous dilemma having two pension beasts to slay at once. They’ve seen record property tax increases to help pay for (but not resolve) the city’s pension crisis, and now face a state income tax hike to forestall (but not resolve) the state’s pension emergency. Will Illinois’ governor and Chicago’s mayor eventually impair bondholders rather than push for sensible pension reforms? We think it’s more likely than not, unfortunately. Neither has been willing to broach the subject of reforms, focusing mostly on new taxes or selling off capital assets like land, buildings and infrastructure. When we add up the projected revenues, the math still doesn’t work. It’s for this reason that we have not and will not own uninsured general obligations of the State of Illinois, or bonds from the City of Chicago and Chicago Public Schools.

This doesn’t rule out investing in Illinois entirely, however. Essential-service revenue bonds—which finance income-producing projects such as toll roads and airports—help eliminate questions about willingness to pay. The returns these bonds generate come from the usage fees these services charge, which are specifically assigned to pay debt service. The bonds aren’t backed by a full faith and credit pledge, but issuers can increase user rates if the dedicated revenue stream falls short. In past bankruptcy cases, revenue bonds proved to have stronger protections than some general obligation bonds.

Is there something that could change our minds about Illinois’ pension dilemma? Yes—a willingness of elected politicians to educate the public on the true scope of the situation and enact sensible pension reforms.


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12. As of March 31, 2019. Municipal bond assets under management figure includes US retail municipal bond fund assets and separately managed accounts.

13. For investors subject to the alternative minimum tax, a small portion of fund dividends may be taxable. Distributions of capital gains are generally taxable.
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All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline.

Investments in lower-rated bonds include higher risk of default and loss of principal. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. Municipal bonds are debt securities issued by state and local governments and are generally exempt from federal income tax and also from state and local taxes for residents in the state where the bond was issued. They typically offer income, rather than capital appreciation potential. Corporate bonds are issued by corporations. Bonds with lower ratings and higher credit risk (risk of default) typically offer higher interest rates to compensate investors for the higher risk associated with the investment.

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