Rating Downgrades and Retiree Benefits

Since the recession, there have been several years when many public pension funds suffered significant asset declines. In addition, liabilities have grown as people live longer and legacy benefit enrichments take their toll on funding. As a result, rating agencies have increasingly taken these factors into account with a number of high profile downgrades.

At the state level we count Alaska, Connecticut, Illinois, Kansas, Kentucky, New Jersey and West Virginia among those rating downgrades that have taken place over the last year alone, in which pension liabilities were mentioned as a factor (see Table 1.) While most rating agencies would argue that they have for some time incorporated a pension analysis into their ratings, the greater financial statement transparency that came with GASB’s revised accounting rules have made pension underfunding much more visible. There could be similar actions once unfunded retiree health promises make their way to the financial statements (although health care benefits have many complex variables that may increase or decrease future costs.)

We caution investors to take a look at the swap portfolios of the lowest rated governments to see what rating changes might trigger acceleration of payments. (This factor is more of an issue at the local level, in our opinion, since state’s tend to be better positioned to absorb termination costs.) Detroit’s swap terminations were a factor in tipping the city into bankruptcy, in our view. Mayor Kilpatrick pledged the city’s wagering tax to secure the swap in lieu of making termination payments when the city’s rating was downgraded. Ultimately, this changed creditor relationships in the bankruptcy.

Chicago converted its variable rate debt to fixed rate and paid off its swap portfolio after the city was downgraded. New Britain, Conn., which we discuss again later, has postponed interest payments on a swap for a year, in exchange for assuming a substantially higher rate when payments resume. Illinois, the state currently closest to the non-investment grade ledge, has agreements with four counterparties but only on one series of bonds (2003B) that were valued at $114 million in their FY2018 Operating Budget Book. The largest of these agreements is with Deutsche Bank (estimated negative $74.5 million

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<th>Table 1: State Ratings that Were Lowered (by at least one agency) From April 2016-March 2017 *</th>
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*Kentucky’s outlook was changed but not the rating

Source: Moody’s, Standard and Poors, Fitch, Kroll, Bloomberg and Wells Fargo

ICR is Implied Credit Rating where there is not a general obligation rating

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Reports available on Bloomberg at WFRE and wellsfargoresearch.com
At the local level, a number of rating actions are worthy of mention. First, well ahead of GASB 67 and 68 implementation on state and local government financial statements, Moody’s Investors Service developed a methodology to put pension expense across their rated universe on more equal footing. The agency uses a uniform corporate bond rate for assessing pension liabilities and came up with an “adjusted net pension liability” calculation or ANPL. A handful of governments with the highest ANPL in the “Aaa” rated category lost their top-grade ratings. Minneapolis and Santa Fe are included in this group as are Elk Grove Village and Evanston, Illinois and a number of highly rated Ohio school districts. Omaha and a handful of others lost their pristine “Aaa” ratings later, for similar reasons.

State-Local Trickle Down
Not surprisingly, local governments in the most pension-troubled states appear in greater numbers in the downgrade lists. On a list we compiled using data from Merritt Research Services, LLC, there were 11 local government downgrades in Illinois, 10 in New Jersey and six in Connecticut. (Note that not all of these downgrades relate exclusively to pension problems and correlation is not causation.) Public higher education, which typically receives large amounts of state aid, tend to follow state ratings. Recently, a cascade of downgrades in Illinois public universities was announced. Failure by Illinois state elected officials to adopt a budget is mostly to blame, but seriously underfunded pension plans are inextricably connected.

School districts, too, are heavy recipients of state aid, and 73 downgrades are noted by Merritt Research Services, LLC across the states. Arizona (5), Illinois (6), Michigan (11), New Jersey (5), Pennsylvania (9) and West Virginia (7) had the most downgrades. The state of Michigan recently increased local district contributions to the Michigan Public School Employee Retirement System from 16.5% of payroll to roughly 27%. For some weaker districts, this increase is a financial burden that contributed to the Michigan downgrades.

Of some interest, two cities in Connecticut received upgrades from A to A+ by Standard & Poors, Hamden and New Britain, while Moody's downgraded Hamden two notches from A2 to Baa1 and New Britain from A3 to Baa1. In the Hamden Moody’s downgrade, the agency cited “elevated pension liability and high debt burden” while New Britain’s Moody’s report cited “extremely heavy debt burden and mid-range pension liability”. New Britain’s debt load includes three pension obligation bonds, which comprise about a third of total direct debt. While the city’s funding level is higher than many, largely due to these borrowings, they continue to grow their liabilities and show a steady decline in funding.

A handy metric that Moody’s uses to analyze whether liabilities will continue to grow, stay the same or decline is its “tread water analysis”. In the supplemental portion of an audit (although the supplemental figures are not subject to audit) there is a “schedule of change in net pension liability”. The ratio works like this: reduce the annual service cost by the employees’ contribution. Look at the difference between the beginning “total pension liability” and the beginning “fiduciary net position”. Calculate the interest on this net liability at the assumed discount rate (e.g. 7.5%) and add to the net service cost. This will be your “tread water” payment which you can compare to what the employer actually contributed. In New Britain’s case, its June, 2015 audit showed a contribution that was $1.4 million less than the “tread water”. Although there are other variables involved, this negative adds to the city’s liability and reduces funding levels unless the city changes policy.

New York State has an interesting program (which some call a “gimmick”) whereby the state and its localities may borrow from the pension plan to make their current year contribution. Since 2010, the plan has accumulated $4.2 billion in receivables according to the comptroller’s 2016 annual pension report. In addition, individual members may borrow against their future pensions. About $1 billion has accumulated. Together, this is a small but growing 2.7% of total assets.

In New York’s case, there was a modest positive in the “tread water” calculation. In other words, the state contributed more than the “tread water” level — which means a modest reduction in the net pension liability (or principal pay down).

The Notching Effect
Most rating agencies rate related securities one or more levels down from the parent rating. For example, appropriation bonds are typically considered less secure given that action by a legislative body is necessary for bond repayment. The Metropolitan Pier and Exposition Authority in Illinois was caught in the cross hairs of the state’s lack of a budget. There was a temporary default due to lack of appropriation for debt service (which the legislature rectified). However, Met Pier’s rating is teetering on the edge of investment grade at BBB– by both Fitch and S&P. Lease transactions may also be notched. State credit enhancement programs are often notched down as well. Public higher education often follows state ratings — as do campus (or off-campus) housing projects as they rely on the credit quality of the school.
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