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Moody's: Bankrupt California Cities Face Steep Climb to Solvency Without Pension Relief.

New York, February 20, 2014 — If the two California cities currently in bankruptcy, Stockton and San Bernardino, exit bankruptcy without overhauling their pension liabilities, the burden of these rising obligations will challenge their recoveries after bankruptcy, says Moody's Investors Service in the report "Without Pension Relief, Bankrupt California Cities Risk Return to Insolvency." Moody's points to the city of Vallejo, which exited bankruptcy in 2011 but still faces steep fiscal deficits, as an example of what may happen if pension reform is not addressed.

"In California, particularly for municipalities with pensions under the California Public Employees Retiree System, or CalPERS, bondholders will likely continue to pay a steep price if bankruptcies remain venues for restructuring debt obligations but pension liabilities remain untouched," says Moody's Vice President — Senior Credit Officer Gregory Lipitz, an author of the report.

Unlike Stockton, San Bernardino has yet to release its plan of adjustment and it could seek to reduce its pension obligations, challenging CalPERS in court. If it did so, Moody's says it could use the recent decision of a federal judge in the Detroit bankruptcy case ruling the city's pension liabilities are contracts and can be modified in Chapter 9.

Although the ruling is non-binding on federal bankruptcy judges in California and limited by aspects of Michigan law, San Bernardino could use the decision as non-binding precedent.

According to Moody's, CalPERS asserts that it cannot be impaired through Chapter 9 bankruptcy because it is an arm of the state, and the relationship between it and California local governments is meaningfully different from the relationship between Detroit and its pension plans. Only litigation will determine if CalPERS' claims are valid.

Moody's says Stockton has not sought to alter vested pension benefits, instead focusing Chapter 9 on debt haircuts, changes to retiree health care benefits, salary controls, increases in employee pension contributions, and lower pension benefit tiers for new employees. The approach is similar to the one taken by Vallejo.

"Vallejo substantially restructured its compensation structure, including significant cuts to retiree health care benefits, but by failing to address its pension liabilities it remains vulnerable to increasing annual payments," says Analyst Tom Aaron, co-author of the report.

Vallejo now faces the risk of a second bankruptcy if its finances continue to degrade. In its budget message the city stated it has a "well below fiscally prudent reserve level" of 5% of expenditures and that by FY 2015 its budget deficit could reach $8.9 million without corrective measures.

For more information, Moody's research subscribers can access this report HERE.