Bond Case Briefs

Municipal Finance Law Since 1971

NYT: Playing Pension Games.

Pity the municipal bondholder. Between Detroit's bankruptcy and the rising concerns over unfunded pensions in Illinois and elsewhere, it has been a rough year for many muni bond investors. While the Standard & Poor's municipal bond index has recovered from its September lows, it is still off 2.7 percent for the year.

A big problem for investors in this $3.7 trillion municipal market — mostly individuals — is that financial disclosures by states, cities and other issuers of tax-exempt debt can be decidedly inadequate.

Securities laws require issuers of municipal debt to provide the information investors need to make informed decisions when buying or selling these instruments. But lax disclosure practices remain, making it hard to spot signs of problems like those hobbling some states and cities. Disclosures about the soundness of public pensions, for example, can be essential to weighing the health of municipal bond issuers that are responsible for funding them.

Investors aren't the only ones who need more information. This was on full display last week, when a judge in Detroit suggested in a groundbreaking ruling that the city's pensioners would not get priority in the city's bankruptcy, and their retirement pay could be considered an unsecured obligation.

John R. Mousseau, executive vice president and director of fixed income at Cumberland Advisers, a money management firm in Sarasota, Fla., said: "Detroit's pensioners may be as eligible to take a haircut as the city's bondholders or vendors. This development should demand more disclosure."

But better disclosure practices among tax-exempt issuers are slow in coming, investors say.

If issuers make material misstatements or omit information, they can face civil or criminal penalties. The Securities and Exchange Commission has brought eight cases contending disclosure failings by municipal issuers this year.

A large case last March involved accusations that the state of Illinois misled investors about its unfunded pension. From 2005 to 2009, a period when the state issued $2.2 billion in bonds, the S.E.C. said Illinois failed to warn investors about the pension system's woes and "the resulting risks to the state's financial condition."

Among the details missing from the state's offering statements and filings, the commission said, were those relating to the contributions made by the state to its various pension funds. The commission said investors were not told that the state was contributing far less to the pensions than was required each year. Last week, the Illinois Legislature voted to shore up the pensions by raising the retirement age for some workers and lowering cost-of-living adjustments. The state is facing a pension shortfall of $97 billion.

Illinois settled with the S.E.C., but the agency did not impose fines or penalties. The S.E.C. doesn't typically exact penalties in such cases, its officials said, because the money would come out of a state or city budget, making matters worse.

Disclosures about pensions in the muni arena rank high as an S.E.C. concern, according to John J. Cross III, director of its Office of Municipal Securities. “Our office expects to take a good hard look at pension disclosure issues,” he said. “It is a major concern because of the magnitude of unfunded municipal pension liabilities and the size and opaqueness of the investment portfolios.”

But the S.E.C. can’t dictate disclosure rules related to accounting, Mr. Cross explained. “We can’t mandate line-item things, but we could highlight more of what we think is appropriate to address material disclosure issues in the pension area as simply and clearly as possible.”

If issuers took the initiative on greater transparency, they’d most likely benefit from reduced borrowing costs, Mr. Mousseau said. Investors who feel confident that they understand the risks in a muni bond will accept a lower interest rate on that security, he explained. “Fewer unknowns in a world fraught with headline risk are a good thing,” he said.

Many people who put money in municipal securities are individual investors looking for a small but safe return, not a big gain on a risky investment. So investors not only need more information from tax-exempt issuers, they also need that information to be relatively simple. That’s the view of Chris Tobe, a public pension consultant and a former trustee of the Kentucky Retirement System. He is also author of “Kentucky Fried Pensions — Worse than Detroit.” He added: “Bad financial practices are a signal of stress down the road and should be disclosed. Investors need to be able to discern between good actors and bad actors.”

A crucial metric that should be found in issuers’ offering statements and filings is one cited by the S.E.C. in the Illinois case: the shortfall in annual contributions that are needed to keep a pension fully funded. Known as annual required contributions, or ARC, many states fail to meet them.

This has the effect of masking an issuer’s financial troubles, Mr. Tobe said. “There almost needs to be a bold statement saying the state is not paying 100 percent of its ARC payments,” he said.

He cites a December 2011 offering statement for $72 million of bonds issued by the University of Illinois. Nowhere does it detail the shortfalls in state contributions to the university system’s pension fund in recent years. Investors seeking this information must go to the Illinois State Universities Retirement System website.

On that website are annual reports and other revealing filings. The fiscal 2012 report shows that for the last five years, Illinois has contributed only 60 percent of the university system’s annual required contributions, on average. With each year the state pays less than the required contributions, the pension fund goes deeper into the hole.

The system has 200,000 members in the defined-benefit plan, 45,548 of whom are retired. The pension’s assets available to pay out benefits fell from 44.3 percent to 42.1 percent in 2012, the report said. The system’s actuarial liability is $19.2 billion.

I asked officials at the Illinois State Universities Retirement System if they planned to offer investors more clarity in future bond offering statements, given the S.E.C.’s recent case against the state.

Thomas Hardy, executive director for the office of university relations, said the pension’s unfunded liability is not the obligation of the university under current state law. But, he said, the Illinois university system’s filings would start including figures on unfunded pension liabilities in its 2015 fiscal year, which begins next July. It will do so to comply with new accounting rules issued by the

Governmental Accounting Standards Board, he said.

That’s a good thing. But many pension problems remain hidden from view. Bondholders lose because “they don’t get the interest rate they deserve for the risks they are taking,” Mr. Tobe said. “While issuers play these games, it’s investors who feel the losses.”

By GRETCHEN MORGENSON

Published: December 7, 2013