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When Pension Pain Signals Bigger Ills: Three Symptoms to Look For.

In my last post , I shared my views on why pension reform is gaining traction in states throughout the country, and why this is generally good news for muni investors. While we do not believe pension problems threaten to harm state and local finances to the point of breaking the municipal bond market (a view shared by the Center for Retirement Research at Boston College), they are a source of financial pain in some locales. And in rare cases, overly burdensome pension liabilities, when combined with a generally weak credit profile, may be reason to avoid investing in the municipal debt of certain issuers.

So how do we spot pension tension? To identify the potential trouble spots, we ask ourselves three questions:

- Does the state or city in question have a pension funded ratio of below 60%?
- Has that state/municipality issued pension bonds to fund that gap? (Incidentally, those bonds are taxable, not your traditional tax-exempt municipal debt.)
- Does that state/municipality also have municipal debt outstanding?
- If the answer to all three questions is yes, that's a signal of pension-induced stress. Importantly, three yeses are required to indicate that the pension problem is having an impact on the local municipal market. Anything less is not quite as worrisome. In addition, the pension problem would need to be accompanied by signs of a weak credit profile to really raise eyebrows. Factors that would elicit red flags around an issuer's credit profile include population declines, low per-capita income, high unemployment rates and high rates of home foreclosure, to name a few.

Detroit is a clear example of a weak credit profile and severe pension pain. The ratings agencies had downgraded Detroit to junk status a few years before its Chapter 9 filing. Pittsburgh, in contrast, also had a large pension problem, but a relatively stronger credit profile. The Pennsylvania city was able to initiate pension reform and ultimately avoided Chapter 9. Pittsburgh now has a better funded ratio, a stronger economy, and was upgraded by the agencies in 2013.

Ratings: An Rx for Change?

Notably, the ratings agencies are being much more proactive in downgrading municipalities and states that are not taking action to address their pension problem. They are acknowledging that states have a significant long-term liability to plan for, which could potentially impair their ability to repay current debt. (I talk about it in my recent Point of View .) And they are grading states and cities accordingly. This is good news for municipal bond investors. Clarity is always a benefit (albeit not a substitute for thorough credit research).

So what's the upshot for muni investors? Pensions are a long-term liability, but a pressing concern for some already weak municipal issuers. More so than ever, ratings agencies and market spreads are factoring in a state's pension status. Where the burden is outsized, the agencies are taking notice and penalizing inaction by issuing rating downgrades. And that has been the impetus for

pension reforms which, ultimately, should help bolster states' long-term fiscal health and contribute to the underlying strength of the municipal market.

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