Bond Case Briefs

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Pension Disputes Raise Transparency Questions for Advisors, Investors.

Financial advisors with tax-free municipal bond funds in their client portfolios may want to reconsider investing in those securities in the wake of the settlement of fraud charges leveled against the state of Kansas.

Federal regulators with the Securities and Exchange Commission (SEC) announced that they had settled with Kansas over misleading investors about the financial health of its public employee pension system in 2009 and 2010.

It is the third settlement with the states in the past four years. Illinois settled last year and New Jersey in 2010.

The repercussions of the underreporting and nondisclosure surrounding pension liabilities mean that retail and institutional financial advisors, fund managers and investors are exposed to risks they don't know about.

SEC regulators said Kansas had accepted the settlement offer "without admitting or denying the findings."

LeeAnn Ghazil Gaunt, chief of the SEC Enforcement Division's Municipal Securities and Public Pensions Unit, said that inadequate disclosure of the state's multibillion-dollar pension liability had left investors with an "incomplete picture of the state's finances and its ability to repay the bonds."

Gov. Sam Brownback said that his administration has adopted policies to disclose pension liabilities in bond offerings.

The Kansas settlement represents the latest attempt by the SEC to bring more clarity and transparency to the $3.7 trillion municipal securities market.

Relatively opaque and loosely regulated compared to the U.S. Treasury market, the municipal market is crying out for more transparency and reform, according to critics and watchdogs.

Over the past several months, the SEC has also brought charges against regional improvement districts and authorities as regulators seek to impose tighter reporting standards and better disclosure among municipal market participants.

Last year, the ratings agency Moody's Investors Service said it would implement changes to the way it analyzes and adjusts pension liabilities as part of its credit analysis of local and state governments.

Moody's Managing Director Timothy Blake said the changes would provide more "transparency and comparability in pension liability measure for use in credit analysis."

Pension obligations "represent a growing source of budgetary pressure for many governments," Blake said.

The ways in which the pension obligations are reported varies widely, “and we believe liabilities are underreported from a balance sheet perspective,” he added.

While the majority of municipal obligations are manageable, pension funding has declined since 2000, when liabilities started to grow faster than assets, according to a study by the Pew Charitable Trusts.

In the SEC’s latest case involving Kansas, investigators said that from August 2009 through July 2010, the Kansas Development Financial Authority raised $273 million through eight series of bonds without disclosing the existence of unfunded liabilities in the Kansas pension system.

Kansas Public Employees Retirement System, or KPERS, manages defined benefit plans for about 1,400 public employers in Kansas, of which the state is the largest employer. KPERS had an unfunded liability of $7.7 billion by the end of 2009.

That made KPERS the second-most underfunded statewide public pension system in the nation after Illinois, according to an analysis by the Pew Center on the States.

SEC investors said that from 2004 to 2009, on the advice of outside accounts, the state changed the way KPERS’ pension liabilities were reported in the state’s annual financial report.

During the five-year period, state financial reports “made no reference to the state’s substantially underfunded pension plan,” even as other states around the country were disclosing similar information, the SEC said.

Similar settlements between the SEC and Illinois last March, and New Jersey in August 2010, involved much larger numbers.

SEC investigators said that in connection with multiple bond offerings raising more than $2.2 billion from 2005 to 2009, the state of Illinois mislead bond investors not only about the adequacy of its pension funding, but about changes to the pension funding plans which include lower pension contributions, as well.

The SEC also said that revealing the “structural underfunding “ of the Illinois pension system to investors would have offered investors a more accurate picture of the state’s financial condition and it’s future financial prospects.

As of fiscal year 2012, unfunded public pension liabilities were as high as $94.5 billion, and the funded ratio was only 40 percent according to the Pew Charitable Trusts.

In the case of New Jersey, the SEC said the state misrepresented and “failed to disclose material information” regarding the underfunding of the Teachers’ Pension and Annuity Fund and the Public Employees’ Retirement System.

The misrepresentations were in connection with the sale of more than $26 billion in municipal bonds from August 2001 to April 2007, the SEC said.

Pew lists New Jersey with a fiscal year 2012 unfunded public pension liability of $47.2 billion and a funding ratio of 65 percent.

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