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Why Muni-Bond Investors are Wondering what Illinois is Going to Do.

Municipal debt investors are watching the appeals process that will decide whether or not Illinois' pension reform bill ends up in the wastebasket, a decision that would send the Land of Lincoln back to square one in its attempts to battle its pension funding crisis.

"There's so much uncertainty there," Daniel Solender, the lead portfolio manager for municipal bonds at investment manager Lord Abbett & Co., said by phone Wednesday. "It's hard to know what the right valuation is [for the state's bonds]."

So far, investors are waiting and watching. Solender noted that there hasn't been much trading in Illinois' bonds in response to a Nov. 21 Circuit Court decision that said the reform bill was unconstitutional. If the Illinois Supreme Court upholds that decision, Solender expects a negative effect on the state's bond values.

"For investors to get comfortable, there has to be some idea of a plan [for pension reform], and there doesn't seem to be one [now]," he said.

Still, he is confident that Illinois has time to work out its pension issues one way or another.

Solender and other sources are looking optimistically to Governor-elect Bruce Rauner, a Republican, to address the issue. Rauner will replace Pat Quinn, a Democrat, on Jan. 12.

Illinois' unfunded pension liability has ballooned to $111.2 billion, according to a November report by the Illinois Commission on Government Forecasting and Accountability. The Teachers' Retirement System accounts for about half of that at $61.6 billion, the report said.

A June 24 report by Standard & Poor's revealed that Illinois has, by far, the lowest level of pension funding in the country at 40.4% funded, followed by Connecticut (49.1%).

As part of a Dec. 1 panel in New York City that discussed municipal debt restructuring, William A. Brandt Jr., president and CEO of Development Specialists Inc., said that Illinois holds 43% of the public pensions in the U.S. According to Brandt, who is also the chair of the Illinois Finance Authority, those amount to some 652 public pensions.

"Illinois is your problem state," he warned.

The pension reform bill, which was approved in December 2013 with the support of Quinn, aimed to address the pension funding gap by raising minimum retirement ages, lowering cost-of-living adjustments, and putting a cap on the base salary that serves to determine pension payments.

However, Judge John W. Belz of the Circuit Court for the Seventh Judicial Circuit in Sangamon County, Ill., ruled on Nov. 21 that the bill violated the state constitution.

The plaintiffs in the case had argued that the bill violated the Pension Protection Clause in the Illinois state constitution, which prohibits impairing or diminishing pensions. The defendants countered that Illinois could enact the pension reform bill using the sovereign powers or police powers granted to U.S. states.

Belz ruled in the plaintiffs' favor, concluding, "The Illinois legislature could not have been more clear that any attempt to diminish or impair pension rights is unconstitutional."

According to Michael Comes, a portfolio manager and vice president of research at Cumberland Advisors Inc., the most palatable pension reforms are ones that affect brand-new city employees. Pension reforms that have been popular among other states recently include raising the retirement age, changing the formula for cost-of-living increases, raising employee contributions to their pensions, or switching employees over to 401(k) plans, Comes said by phone.

Moody's Investors Service Inc. expressed skepticism that the state Supreme Court would reverse the circuit court ruling.

"While a lower-court ruling can, of course, be reversed, this summer the Illinois Supreme Court indicated in a separate case on retiree health benefits that it will adhere strictly to the pension protection clause, a legal barrier that for many years has impeded political consensus on reforms affecting current Illinois pension participants," the ratings agency said in a Nov. 24 report.

Illinois' credit rating of A3 is the lowest among U.S. states, five notches below the median, Moody's said.

The ratings agency added that Illinois' ratio of adjusted net pension liability to revenue was 268% in 2013, well above the 60% median for all states.

In a Nov. 11 report, Moody's Analytics referred to Illinois as "the country's most financially troubled state."

S&P singled out Illinois alongside Kentucky, New Jersey, and Pennsylvania as states with credit quality harmed by pension funding issues.

According to an April 8 report by the Pew Charitable Trust, state-run retirement systems had a shortfall of $915 billion during fiscal 2012, a number that ballooned to more than $1 trillion when local government obligations were considered, as well. That number is up from $452 billion in fiscal 2008.

If the state of Illinois and its municipalities struggle under their load of obligations, they won't have access to municipal bankruptcy protection. States are prohibited from filing for Chapter 9 under the federal bankruptcy code, and Illinois doesn't have a mechanism that would allow its municipalities to file under that section.

Brandt noted that major Chapter 9 filings such as those of the City of Detroit, Mich., and Jefferson County, Ala., aren't your "customary" bankruptcy filings — they are "event-driven."

He notes that for some struggling municipalities, they are "corporate entities that may or may not need to exist any more."

The Street

By Lisa Allen | 12/11/14 – 09:25 AM EST|

— Kelsey Butler contributed to this report