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FT: Muni Risk Rises as Pensions are Put First.

A low hum of anxiety has surrounded the issue of public pensions in the US municipal bond market for years. Now, that hum is getting louder.

The third largest city in the US became a junk rated issuer when Moody's last week cut Chicago's credit ratings on concerns about its unfunded pension liabilities. The downgrade is the latest in a string of high-profile instances of pension woes spilling into the bond market at a time when investors, rating agencies and rulemaking bodies are scrutinising pensions.

"Politicians and other government stakeholders besides the pensioners themselves are taking pensions much more seriously," says Matt Fabian, managing director at Municipal Market Advisors. "The long-term promise of pensions had been taken rather lightly. Because the costs were so far into the future, political managers and others really dismissed pensions as a threat to solvency."

Pensions have been increasingly thrust into the spotlight, having become a significant factor in the most widely watched municipal distress stories.

Puerto Rico's pension is funded at just 5 per cent. Pensions have also played a large part in municipal bankruptcies, most notably in Detroit where a bankruptcy judge put limits on cuts to pension benefits at the expense of bondholders.

Governments have been poor managers of their pensions for some time, but the financial crisis and ensuing recession lifted the veil on chronic underfunding and rosy return expectations. Stock market declines deepened unfunded liabilities considerably while states, cash-strapped by the economic downturn, had less money to plug the gaps.

Academics and other analysts began to publish calculations of a few trillion dollars for the total funding gap, grabbing attention from, and contrasting with, the official numbers, which benefited from unique and controversial accounting.

Against this backdrop, Moody's a few years ago changed its rating methodology to give more weight to pension issues, while new accounting rules are coming into effect and will provide more transparency and a financially conservative view of pensions.

"We're on the cusp of evolutionary change related to pensions. What we're seeing is a clear indicator that courts are willing to treat pension beneficiaries as ahead of creditors," says Thomas McLoughlin, head of municipal fixed income at UBS Wealth Management Americas.

"That will transform the risk parameters for municipal finance. For years muni analysts looked at idiosyncratic credit risk, but now we are looking at a systemic risk related to pensions. It's a really important trend we have to incorporate into our analysis. We have to focus far more on this in the future."

"Munis" are reflecting only modest pension risk. Chicago was penalised by investors after its downgrade. Yields on the city's 10-year bonds have risen by about a percentage point since. States with poorly funded pension systems, such as Illinois, New Jersey, Pennsylvania and Connecticut, have higher borrowing costs than their peers.

Many muni investors believe there is time to fix most pension problems. Even if that does not happen, the day of reckoning is far into the future and governments have a lot of options, as the argument goes.

“The most likely scenario is rather than triggering defaults or insolvency, pensions will squeeze out other spending, such as infrastructure investment, educational spending and social services,” Mr Fabian says. “It is not a great scenario, but different than default or bankruptcy.”

Indeed, even the more troubled pension systems do not face imminent threats of running out of money. Several states, including Rhode Island, Minnesota and Colorado, also have been successful in enacting reforms to shore up their pensions.

Others, like Illinois, have been blocked by the courts — its thwarted reform bill was a key factor in the Chicago downgrade.

Pensions are governed by state law, which means the reception to change varies. The meatier cuts to public pensions — those that involve existing rather than new hires, and accrued benefits — clash with contract law, case law and in some cases state constitutions.

The financial markets play a big role, too. The pension drama has played out at a time of very easy monetary policy. One question is what kind of rate investors will demand for bonds of areas with more pension risk once rates rise.

The bull run coming off the financial crisis and taking US equities to new highs has helped pensions, but critics point out that pension plans have increased their risk-taking, with larger allocations to equities over the years. Ratios of existing workers to retirees have also moved decidedly in the wrong direction.

“The ratio is an indication that plans are getting more mature and need to pay out more benefits, and that they are increasingly reliant on investment income, which is scary,” says Don Boyd, a fellow at the Nelson A Rockefeller Institute of Government.

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