Pension Risks Point to Higher 2016 Borrowing Costs for Some U.S. Cities.

NEW YORK — Some U.S. cities may have to pay higher interest rates to borrow money in 2016 as they contend with a host of new pressures on their underfunded public pensions, including new reporting rules and the impact of this year's tepid investment returns.

The recession-era ghost of public pensions problems will continue haunting the $3.7 trillion U.S. municipal bond market next year, investors and analysts told Reuters.

Investors are expected to demand greater compensation, especially for financially weak municipalities that for the first time will have to move unfunded pension liabilities from the footnotes of financial statements to their balance sheets.

"A lot of local (general obligation bonds) don't have, in my opinion, the cheapness to compensate for this new information flow we're going to get," said R.J. Gallo, senior portfolio manager at Federated Investors in Pittsburgh.

When interest rate spreads widen on a city's general obligation (GO) debt, its existing debt underperforms and usually leads to higher rates for new borrowing.

Investment losses during the last U.S. recession – which ended in 2009 – laid bare the fact that many states and cities shortchanged their public employee retirement systems for years. In the third quarter of 2015, unfunded liabilities rose nationally to a near three-year high of $1.71 trillion combined, according to Federal Reserve data.

To be sure, municipal bonds outperformed every other U.S. fixed income product in 2015, returning 3.23 percent as of Dec. 21, according to Barclays' Municipal Bond index.

But well-known pension problem spots like Chicago, and states such as Illinois, New Jersey, Pennsylvania, Connecticut and Kentucky will continue to be causes for investor concern.

In addition, a new rule from the Governmental Accounting Standards Board (GASB) that moves unfunded liabilities onto city and state balance sheets is expected to highlight new problem areas.

The rule, GASB 68, will make lesser-known places like Billings, Montana appear in worse shape than previously thought, according to a forthcoming report by the Center for Retirement Research at Boston College.

Reuters exclusively reviewed a draft of the report, which is expected to show that in 92 cities that pay into a cost-sharing state pension plan, unfunded liabilities as a percentage of city revenues will nearly double, to 70 percent in aggregate from 37 percent.

Cities that participate in such state plans do not always have control over their contributions or shortfalls. But other cities that run their own independent plans, such as New Haven, Connecticut,

are also expected to look worse.

The rule is in effect for fiscal years ending June 30, 2015 and later. While it will not increase actual liabilities or change required pension contributions, it will make shortfalls more apparent and potentially raise risk premiums.

Moody's Investors Service has a stable 2016 outlook for both state and local government sectors – with the exception of those "unable to make progress toward funding large pension liabilities."

Compounding the picture is a changing perception about the GO bond pledge itself after the cities of Detroit and Stockton bankruptcy judgments put bondholders below pensioners – making an under-funded pension a bigger potential problem for investors which buy GO debt.

"The GO pledge, the pledge that the municipal market for its entire existence viewed as sacrosanct, now isn't," said Nicholos Venditti, portfolio manager at Thornburg Investment Management in Santa Fe. "Given the strength of the muni market this year, I don't believe investors have been compensated in general for that incremental risk."

By REUTERS

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