
After Bankruptcies, Murky Future for California POBs.

LOS ANGELES — The future of pension obligation bonds remains cloudy in California in the wake of the haircuts imposed on their holders in the San Bernardino and Stockton bankruptcies.

Municipal bond industry professionals interviewed for this article disagreed about the future viability of POBs in California.

Tom Schuette, partner and co-head of portfolio management for Gurtin Fixed Income, said the firm holds some of the taxable securities for its investors.

“As with all securities, we are highly selective and look to the overall credit quality of the obligor,” Schuette said.

“We believe the bankruptcies are a reminder to avoid distressed obligors, which Stockton and San Bernardino were, not a cautionary tale to avoid entire security classes,” Schuette said. “We would anticipate that while obligors may have to pay up slightly to issue POBs in the future given the losses felt by San Bernardino bondholders, we still would expect high quality obligors to be able to find a receptive market.”

Schuette says the prices in California pension obligation bonds have not changed in the last month, and that POBs from high-quality California obligors are generally trading slightly off of their GO debt, but not by significant levels, he said.

California taxable pension obligation bonds were pricing in the 3.09% to 4.6% range for 10 years and in the 4.84% to 5.57% range for 30 years on Tuesday, according to Markit.

Marilyn Cohen of Envision Capital Management said she never thought POBs were a good idea – even before the bankruptcies.

“I have been railing against how pension obligation bonds should not be in anyone’s portfolio for a long time,” she said.

She thinks the tough treatment of POBs in the two California bankruptcies will give future investors — and issuers — pause.

“As the stresses continue in pension liability, investors will demand more and more yield, so that it will be untenable for issuers to sell POBs,” Cohen said.

She said she won’t but her money or her clients’ money in POBs because the rate of return does not match the risk.

In the San Bernardino Chapter 9, the settlement deal with pension obligation bondholders and insurers calls for the city to give them what it describes as a 40% recovery over the long term.

It’s significantly more than the 1% the city first proposed, but continues a trend of bonds faring worse than pensions in Chapter 9 cases, as in Vallejo, Calif., Detroit and Stockton.

John Knox, a partner with Orrick, Herrington & Sutcliffe, said investors should not have been surprised that the pension obligation bonds were impaired, because they are an unsecured credit – and that is how unsecured credits are treated in bankruptcy.

“Clearly, the Stockton case and San Bernardino have both shown — which is not a surprise to me or other bond lawyers — that pension obligation bonds are an unsecured promise to pay by the municipality,” Knox said.

POBs are a promise by the municipality to pay, just like borrowed money on a consumer line of credit, Knox said.

“I think folks thought there was more there, they might have thought there was some additional level of security,” Knox said. “If you are dealing with an unsecured obligation and there is a secured obligation, the secured obligation is more likely to be paid.”

He added he doesn’t think the decisions in the bankruptcies have changed the rules.

“If you have an unsecured obligation and the debtor goes into bankruptcy, that is likely to be impaired,” Knox said.

Though the California cases don’t change the rules of the road, Knox does think they will change investor perception of pension obligation bonds.

“I have always scratched my head when rating agencies rated POBs higher than lease obligations, but I’m not a rating agency,” he said.

While the asset backing a lease obligation could be damaged or destroyed, the bonds do have that asset backing the bonds, which provides some level of security, he said.

But for whatever reason, before Stockton, the rating agencies tended to rate POBs a notch higher than lease obligations, he said.

“As far as I know, nothing represents a change in structure for pension obligation bonds, or represents anything people should be surprised about in how they were treated in bankruptcy,” he said, “because any unsecured obligation is at higher risk than a lease obligation.”

Knox thinks the structure of future California POB issues could evolve into lease-backed financings.

“I am not surprised when any investor is upset about being impaired in bankruptcy,” he said. “Before Vallejo, Jefferson County, Stockton and Detroit there was a feeling that munis would never go bankrupt – and you did not have to think about it too much. Now that a few have – and it is a small number compared to the universe of issuers – I think people are waking up and saying: ‘If this does happen, what do we have?’ In the case of a pension bond, it’s an unsecured obligation.”

In San Bernardino, the European bank that held the POBs raised the argument, rejected by the court, that if the city keeps paying pensions it should continue to pay the pension bonds, Knox said.

“I have heard that argument before, it holds no water,” Knox said. “The fact that they settled for the amount they did belies the fact that creditors didn’t believe it either. In one case, they didn’t even raise it. In San Bernardino, they raised it but lost.”

Investors should have been drawing distinctions between general obligation bonds, pension obligation bonds and lease revenue debt, Knox said.

“Muni bonds aren’t monolithic,” he said. “There are scores of different kinds of muni bonds. They have different credit scores and different payment sources. I don’t see that that is different from 10 years ago. Now that a few have gotten into trouble, people realize they were not paying enough attention to the distinctions.”

According to Robert Christmas, a Nixon Peabody partner, the issue always boils down to one question: What is the nature of the security?

“Pension obligation bonds are one of the elephants in the room for municipal finance and they are going to have to be dealt with,” Christmas said. “And maybe issuing bonds to deal with pension liability is not the way to go.”

Pensions are clearly a huge issue in municipal finance in terms of the solvency of the issuers, he said.

“The focus to me is not the subject of the issuance, but what is the statutory framework in that state for bondholders,” he said. “We have clear statutory liens or narrow issuance for revenue bonds, which are protected under the bankruptcy code.”

What Stockton and Detroit pointed out is that while investors might think they have a lien, they may not because the statute isn’t clean, Christmas said. That is what led to haircuts for bondholders in the Detroit workout.

“I haven’t worked on a POB deal, but it strikes me that they are from another era where there were ever higher pension costs and no one thought the market would tank on that,” Christmas said.

What investors need to contemplate is whether POBs are helping to smooth out the operations of a municipality or are a Band-Aid hiding a larger issue, he said.

“As we saw in Stockton and San Bernardino, a lot of issuers don’t have the appetite to litigate over claims priority with state agencies (like the California Public Employees’ Retirement System), to whom they owe money,” he said. “And agencies might have statutory frameworks involving the cities owing pension funds money.”

Cities must also weigh their ability to market bonds in the future if they give bondholders to steep of a haircut, whether on pension obligation bonds or other bond categories.

“We know in Chapter 9 everyone is going to take a haircut,” Christmas said. “If you cut the hair to short, you aren’t back in the market. It could be years (before a city is able to market bonds again).”

Orange County, bankrupt in 1994, was able to sell bonds not too long afterward, as part of California’s strong coastal economy with strong property values and affluent taxpayers, Christmas said.

Investors take that into account, he said.

The Inland Empire’s San Bernardino and the Central Valley’s Stockton, with high crime rates and less affluent populations and tax bases, don’t have the same economic strengths going for them.

The Bond Buyer

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