Bond Case Briefs

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Record Number of Muni Issuers Bet on Pension Debt With Rates Low.

- **74 issuers have sold in 2021, unprecedented year-to-date tally**
- **Governments see chance to borrow cheaply, invest in stocks**

Unprecedented number of muni issuers selling pension debt

A record number of U.S. state and local issuers are selling debt to pay for retirement benefits, tapping borrowing costs near historic lows as they eye surging returns in investments such as stocks.

Seventy-four issuers have sold debt to finance pension costs in 2021, the highest number year-t--date in records starting in 1999, data compiled by Bloomberg show. The combined amount of more than $10.3 billion, encompassing all bonds where at least a portion of the proceeds goes toward pension funding, is the highest since the all-time peak in 2003, which included a $10 billion Illinois sale.

The offerings have come from states and an array of other borrowers, including cities, townships, fire and school districts, a community college and a university. Growing unfunded liabilities, which add budget stress each year, are a key driver, and with some Wall Street banks anticipating higher long-term rates, the timing appears right. For UBS Group AG's Tom McLoughlin, it adds up to a third major wave of such sales, after one following the 2008 financial crisis and another in 2003.

"The low rates in the market, if they persist, you could expect this wave to be larger," said McLoughlin, head of fixed income, Americas.

Municipalities nationwide are grappling with a pension shortfall that amounted to around $4.5 trillion as of 2018, according to the Federal Reserve's latest analysis. Years of underfunding and aggressive assumptions for returns at times were big contributors. The pain is only increasing now as the slow recovery in state and local employment from the pandemic has left fewer workers contributing to retirement systems, McLoughlin said.

The gamble for issuers is that they'll be able to earn more investing the proceeds of the bond sales than they need to repay the debt. It's been an appealing option in 2021, with major stock indexes marching to a series of record highs, even as valuation questions are mounting.

'Pros and Cons'

In June, when the border town of Douglas, Arizona, sold almost $39 million in pension-obligation securities, it looked "at the pros and cons extensively, and felt this was the best way" to avoid a crisis down the road, said its mayor, Donald Huish.

The community had expected its annual fire and police pension payments to jump to $4.4 million in 2038, from $2.4 million in fiscal 2022, Huish said. Douglas sold the debt with an average rate of about 2.9% and projects a 7.3% annual return.

Many issuers are drawn by the arbitrage opportunity and the bonds “probably look pretty attractive” said Lisa Washburn, a managing director at research firm Municipal Market Analytics. The risks they carry, however, mean they’re “not a sure thing.”

The Government Finance Officers Association has advised against using them and analysts warn that they take a “soft” liability such as an annual contribution that some governments reduce in times of financial challenges and turn it into a hard liability, like fixed debt service.

A spokesperson for Stifel, which has managed the most such deals in 2021 — 27 of the 74 sold — said the firm didn’t have a comment.

Timing Challenge

The catch with pension bonds is two-fold. First, they don’t offer a permanent fix to the fiscal strains that pushed municipalities to sell them, says Michael Rinaldi, a Fitch Ratings analyst. The second is the issue of market timing.

Timing worked against Stockton, California, which sold pension debt in 2007 and filed for bankruptcy in 2012. The 2008 crisis drove investment returns below assumptions and the bursting of the housing bubble slashed revenue collections.

One reason for confidence now is that Treasury yields remain low by historical standards, with 30-year rates hovering below 2%. The yield will probably be closer to 2.6% a year from now, according to the median forecast in a Bloomberg survey.

In August, Kansas sold about $500 million of pension bonds, its first such issuance since 2015, “to take advantage of the attractive interest rates in the bond market right now,” Adam Proffitt, the state’s budget director, said in an email. Proceeds will go into the public pension system to pay down a portion of its unfunded actuarial liability and accelerate payments, he said.

Dozens of smaller governments have jumped in as well.

Localities are addressing “unsustainable” costs and unfunded liabilities that are threatening the ability to serve residents, said Kevin Phelps, city manager for Glendale, Arizona, which issued about $253 million in pension bonds in June. The city pays around $50,000 a year per firefighter and per police officer into the retirement system, close to the median household income in the community, he said.

The sale of almost $54 million in pension debt in recent days by Naugatuck, Connecticut, will go toward financing unfunded retirement obligations for borough employees and firefighters. The borough ended its defined-benefit pension plan in 2012 and shifted to a 401(k) plan for new employees to ease pressure on its budget long-term.

“We can definitely see the end,” said Mayor Pete Hess.

Bloomberg Markets

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September 9, 2021, 11:00 AM MDT

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