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Illinois Local Governments Offer Steady Stream of Pension Bonds.

The wave of local Illinois governments turning to pension obligation bonds shows no signs of abating and could accelerate amid concern that the window is closing on record low interest rates.

Wheaton sold $46 million last month. Berwyn is eyeing an issue and Moline plans to follow its neighbor East Moline into the market.

They continue a trend that made Illinois the third largest source of POB issuance, behind California and Arizona, among local governments rated by S&P Global Ratings from the start of 2020 through September 2021.

“Pension and other postemployment benefit obligation bond issuance is accelerating in the U.S.” spurred by a favorable interest-rate environment and local government efforts to control rising contributions, S&P said in an October report.

“We expect continued issuance accelerations as issuers compare peers’ seemingly successful transactions with their own large and growing unfunded liabilities, and some issuers might anticipate the end of record low interest rates” as the Federal Reserve considers tapering asset purchases and raising the federal funds rate, S&P said.

Factors unique to Illinois contribute to the allure of pension borrowing there. The state and many of its local governments fell behind on pension funding over years of contributions built into state law based on schedules tied to factors like employee contributions that fell short of an actuarial level.

One anti-POB argument – that it creates a hard debt service liability from a softer pension obligation with some payment flexibility – is less persuasive in Illinois where the state constitution protects promised retiree benefits against impairment or diminishment and the state’s high court has ruled against Chicago and Illinois’ efforts to cut benefits.

“Many here have come to believe that pensions are a hard liability because of the constitutional mandate and so that can offer a better argument to borrow if the pension cost is already considered a hard liability,” said Richard Ciccarone, president of Merritt Research Services.

State law also now allows for most pension funds to intercept tax revenues or grants that flow through the state if local governments fall short of actuarially-based contributions. Ciccarone cautions that a hard default on bond payment can carry more serious consequences for a borrower than falling short on pension contributions.

POBs draw varying opinions from market participants.

The Government Finance Officers Associations recommends against their use because of the risks that the play on arbitrage between debt service on the bonds and investment earnings on the proceeds will pay off.

Ciccarone is among those that believe POBs can play a role in managing a balance sheet but only in the presence of some type of reform, whether it's on the benefit or payment side, and even then cautions that risks remain.

"I don't take that hard core line against them if they are done for the right reasons and they serve as a mechanism for reform that helps the long term health of the borrower," Ciccarone said. "The key question is whether they can afford and stomach the debt service because there is still risk," especially for governments with a limited economic base that lacks growth.

Pension burdens weigh heavily on the ratings of Chicago, the state government and some other struggling local governments due to a flawed funding system and legislative action to date has made little headway in solving the quagmire, S&P Global Ratings warned in an August report.

Downstate and suburban public safety funds carried $11 billion of unfunded liabilities in 2017 – up from $10 billion a year earlier – with an average funded ratio of just 55%, according to a 2019 report from the Illinois Department of Insurance.

The state government's unfunded liabilities rose to a peak $141 billion last year for a 40.4% funded ratio and Chicago carries a $33 billion tab with its firefighters fund 18.97% funded, its police fund 22.21%, the municipal fund at 22.96% and laborers at 44.42%.

The par of pension-related borrowing issued this year has reached around $11.2 billion, said Lisa Washburn, chief credit officer at Municipal Market Analytics. Illinois ranks 4th in terms of par issued and 3rd in number of issuers.

Washburn, who believes municipal governments should avoid POB risks, cautioned that the data from Bloomberg includes a broader range of pension financings, such as Illinois? $850 million issue which earmarked just a portion for a pension buyout program.

Most Illinois-based POB borrowers are paying down their public safety pension plans to meet a state mandate for public safety funds to reach a 90% funded ratio by 2040. If local governments outside Chicago don't make an actuarial payment, pension funds for the last several years have enjoyed the ability to file claims to intercept various tax or grant revenues that flow through the state.

Actuarial contributions have long been required for the Illinois Municipal Retirement Fund which covers general employees outside Chicago and Cook County, and it is 91% funded.

The Illinois Public Pension Fund Association, which represents public safety funds, last year encouraged local government leaders and fund managers to explore the POB option. It lays out the benefits and risks last year in an "informational bulletin."

Many of the Illinois-based local governments issuing POBs are near or fully funding their public safety obligations or setting aside proceeds into a special account to manage the strain of rising contributions on their budgets.

The impact of ratings varies depending on a POB deal's structure, the overall impact on a borrower?s balance sheet and whether the added debt service limits budget flexibility, and its underlying fiscal health.

"Key credit risks, while unique to each U.S. public finance issuer, primarily include market returns falling short of expectations and pension contribution increases pressuring budgets," S&P analyst Todd Kanaster said in the agency's October report.

S&P rated 64 new POB issuances totaling nearly $6.3 billion between January and September 15. That more than doubles rated POB issuance over the $3 billion issued in all of last year.

S&P has observed some changes with the fresh run of borrowing. Some are veering from tradition in using non-GO pledges and more school and park districts are using the tool. Some borrowers also are setting aside some proceeds to mitigate future budget stress.

All of those factors been seen among Illinois-based POB issuance. So far this year, S&P has rated at least six Illinois POBs.

The Addison Fire Protection District, the Bensenville Fire Protection District No. 2, DuQuoin, Elmwood Park and Wheaton all paid down police and firefighter obligations and Geneseo paid down police obligations.

Wheaton held on to its AAA rating and stable outlook from S&P when it sold $46 million of taxable GOs to fully fund its police and firefighter pension plans in a deal underwritten by Stifel and Piper Sandler (PIPR). Baird was advisor.

“The rating reflects our view of such factors as the city’s very strong economy, management, budgetary flexibility, and liquidity, and its strong budgetary performance,” said analyst Katelyn Kerley.

The Chicago suburb used the proceeds to pay down public safety liabilities with plans to make 12 equal monthly installments to mitigate market timing investment risks and proceeds also established a budget reserve that can be used to pay down liabilities.

Berwyn and Moline are teeing up deals.

S&P put Berwyn’s BBB GO rating and A-minus securitization corporation ratings on CreditWatch Developing as it assesses the proposed borrowing’s impact. Berwyn would also include a debt restructuring in the deal. The placement indicates there’s at least a one-in-two likelihood of a rating change within 90 days, S&P analyst Blake Yocom said in the Sept. 30 report. The review continues, Yocom said this week. COVID-19 pandemic related pressures prompted S&P to revise the Chicago suburb?s outlook to negative in June 2020.

Moody’s Investors Service affirmed at A1 the city of Moline which plans a $90 million taxable GO issue.

Moline’s borrowing to pay down its public safety tab along with a $3.2 million series for its aquatic center will bring its debt to $120 million.

“The city intends to limit the required increase in future pension contributions with the issuance of pension obligation bonds, though this strategy detracts from the city’s overall credit quality by heightening its exposure to potential investment losses,” Moody’s said.

East Moline suffered a two-notch downgrade from Moody?s in September that left its rating at Baa2 as it prepped a $41 million POB issue. Moody’s (MCO) raised concerns over the risky strategy but said the borrowing itself didn’t drive the downgrade. Moody’s attributed its action to the sum of the city’s bonded, pension, and other post-employment benefits burdens.

Baird was underwriter and Speer Financial advised the city. In addition to a GO pledge, the bonds were secured by tax receipts levied for police and fire pensions and corporate purposes, distributions of personal property replacement taxes and sales taxes collections distributed by the state.

Bradley in Kankakee County earlier this year sold $11.9 million to cover its police unfunded liabilities and raise the funded ratio of 61% and fund a budget stabilization fund. The village used higher-than-expected revenues to fully fund its firefighters’ fund.

Freeport in 2020 sold $52.7 million of taxable GOs to fully fund its police and firefighter funds that combined were less than 45% funded. The bonds carried insurance from Build America Mutual.

Baird according to its website served as the sole underwriter on Freeport’s deal along with the city McHenry’s $24.3 million POB deal in 2020. So far this year it has been senior manager on Addison Fire Protection District?s $33.8 million deal and sole manager on East Moline’s deal.

By Yvette Shields

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