HilltopSecurities
A Hilltop Holdings Company

Recent Events Reinforce Questions of Willingness and Ability to Pay

IT IS NEWS, NOT JUST NOISE

Tom Kozlik
Head of Municipal Strategy & Credit
214.859.9439
tom.kozlik@hilltopsecurities.com

Summary

- Municipal bond market observers and participants may be underreacting to recent, important credit-related municipal bond market news.
- This commentary summarizes several examples of this news and notes why they are important. Examples include Kentucky's pension crisis, Alaska's cuts to higher-ed funding, John Tillman's lawsuit against Illinois, Chicago's request for pension assistance, an institutional investor's questioning of the GO pledge, the Fed's shift in how it measures pension liabilities, and New Jersey's manipulation of its discount rate to aid its budget.
- These events reinforce questions of issuer willingness and ability to pay. It is likely that similar pressures will result in additional incidents in the near future that should not be ignored.

Relevant Municipal Credit News, Not Just Market or Political Noise

The U.S. economy has grown for a record 121 consecutive months and just began its 11th year of its economic expansion. It seems the municipal bond market and especially state and local governments are enjoying the benefits of broader U.S. growth. Investor appetite in the form of flows into municipal funds is record setting—keeping spreads tight and borrower costs low—and the rating agencies have "stable" outlooks on the state and local government sectors. While it seems like a general optimism exists throughout the nerve center of municipal finance, is this optimism warranted?

While it seems like a general optimism exists throughout the nerve center of municipal finance, is this optimism warranted?

This optimism clashes with recent municipal bond market-related news—events that are important indicators of the financial health of state and local governments. In some—if not all—cases, the question about an issuer's ability and willingness to pay is even at issue. However, the market has seemingly ignored these events, leading us to believe observers and participants have become desensitized to pertinent stories and incidents. Below we review a few recent examples of important news items that appear to have gone unnoticed but probably shouldn't have.

Kentucky's Pension Crisis

Kentucky is currently navigating its way through a bonafide public pension crisis. With just over 132,000 participants, the Kentucky Employees Retirement System: Non-Hazardous employees (KERS-NH) is the state's second largest public pension plan. The plan is just 12.84 percent funded, only has about $2 billion worth of assets, and a little over $980 million of benefit payments were paid in FY18.

Kentucky lawmakers are considering drastic measures. As of July 1, plan participants face an unaffordable 70 percent increase in pension contributions. As a result, the Kentucky legislature called for a special session last week (the week of July 15) to consider their options, all of which to date stand to increase the amount of liabilities and do not solve the imbalance. There are no good politically attractive options and

Please see analyst certifications and disclosure starting on page 4.

Kentucky has all but spent its rainy day fund. Lawmakers will likely continue to spend time nibbling around the edges until they're forced to make difficult decisions, and the municipal bond market is going to learn much about the state government's willingness and ability. Kentucky has about $6.7 billion of lease and $1.3 billion of moral obligation debt subject to appropriation.

University of Alaska Downgraded, Declared Financial Exigency

A key credit advantage for state governments is their sovereign ability to manage their revenues and expenses. States mostly make changes on the expense side, not the revenue side. We saw a meaningful example of this recently when Alaska cut its state-appropriation funding to the University of Alaska (UA) by 41 percent. Like many state universities, UA is highly dependent upon state funding, which makes (or made) up about 50 percent of all funding sources, so a 41 percent cut is a substantial credit event. As a result, Moody's downgraded UA to Baa1 from A1 and assigned a "Negative" outlook in the middle of July.

University of Alaska is is highly dependent upon state funding, which makes (or made) up about 50 percent of all funding sources, so a 41 percent cut is a substantial credit event.

UA's Board of Regents declared financial exigency on July 22. By declaring financial exigency, a university can shed its largest expense, personnel, more quickly. The university can terminate tenured faculty positions, restructure, and cancel departments and programs without going through traditional procedures. Financial exigency should not be compared to bankruptcy and does not provide the same benefits as federal bankruptcy protection.

Lawsuit Filed to Void $14 Billion of Illinois GO Bonds

At the beginning of July, John Tillman, chairman and CEO of The Illinois Policy Institute and Warlander Asset Management, a hedge fund and bondholder, filed suit against the state claiming portions of 2003 and 2017 issues were unconstitutional.

The lawsuit itself is unlikely to be successful. However, the filing does symbolize a shift in the holders—or potential investors—of some municipal bonds. Hedge funds do not often buy municipals but they have on occasion as opportunities present themselves. It is important to remember this type of investor will not likely be as accommodating during a restructuring as traditional municipal bond investors have been.

The lawsuit highlights the almost sub-investment grade credit status of Illinois and should cause observers to think about Illinois' credit fundamentals.

The lawsuit also highlights the almost sub-investment grade credit status of Illinois and, frankly, should cause observers to think about Illinois' credit fundamentals, whether the state is able to pay all creditors (including bondholders), and the burden overlapping bond and pension obligations Illinois (state of), Cook County, the Chicago Board of Education, and Chicago create as a whole.

Rating Agency Analyst Contemplates a Possible Illinois Restructuring

Equally important when it comes to Illinois is a meaningful scenario recently posed by a public finance rating analyst. During a presentation about Illinois-related public finance topics, the analyst asked, "Will there be a restructuring down the road for Illinois?" only to quickly follow up with, "Nothing seems imminent but [the] long-term rating trend and [the] lack of action on the pensions could lead to some type of restructuring."

It is important to note while Illinois' spreads widened out by about 35 basis points since the beginning of July, they are still at a 175 basis point difference to the AAA municipal benchmark. Illinois has been trading at about a 175-180 basis point spread to the AAA municipal benchmark going back to October 2018, outside of a few months in 2019 when the spread slightly tightened.

Chicago Asks Illinois for Help with Pension Liabilities

That brings us to the latest in Chicago. There is a significant reason why newly elected Chicago Mayor Lori Lightfoot asked the state for help with its pension liabilities at the beginning of July—the city's pension plans are at risk of becoming insolvent. The city cannot afford to pay a meaningful level close to the actuarially determined amount into their pension plans, and it's unlikely the city would be able to afford the pay-as-you-go payment. For those who were not following, Illinois Governor Pritzker answered Mayor Lightfoot's request by saying, "There are not liabilities that can be adopted by the state that would not drive us into junk status."

Chicago cannot afford to pay a meaningful level close to the actuarially determined amount into their pension plans, and it's unlikely the city would be able to afford the pay-as-you-go payment.

When Mayor Lightfoot requested Illinois consolidate—or otherwise help with Chicago's pension liabilities in some manner—it appeared the new mayor, after reviewing the above status, recognized the bleak outlook and was searching for options. We did not view this request as simply noise but as an important indicator of the credit status of one of the largest cities in the U.S. It is difficult to forecast what Chicago leaders will recommend, so it is easy to assume the city will rehash the same choices they have relied on in the past. If Chicago continues to contribute less than their required contributions, the asset levels will worsen while the pension plan(s) remain at risk of becoming insolvent.

State and Local Government Public Pension Plans are Only Funded at 47.5 percent

The pension plan funded ratio is one of the more commonly cited ratios for state and local governments. The Center for Retirement Research at Boston College ("the Center") is the most commonly cited source for this ratio, which market observers have typically relied upon to express the overall funded status of public pensions. The Center's most recent data point—based on the aggregate of larger state and local government plans and their discount rates—recently showed an overall FY17 funded status of 72 percent.

In September 2018, the Board of Governors of the Federal Reserve System ("the Fed") increased the unfunded pension liabilities for U.S. state and local governments to over $4 trillion compared to the $1.7 trillion they reported in the prior quarter. The increase in liabilities dropped the funded status to 47.5 percent from a number closer to what the Center reports. The Fed's change was not market related, but rather a result of an accounting shift. Notably, the Fed started to use an Aaa corporate bond index as a discount rate, which is very similar to the Aa corporate bond index Moody's uses in calculating its adjusted net pension liability (ANPL). This accounting treatment highlights the lack of clarity in how the Fed calculates liabilities as well as the fact that the pension liabilities state and local governments think they are prepared for are actually much higher.

The Fed's change was not market related, but rather a result of an accounting shift.

Platte County, Missouri, Not Required to Appropriate Funds

On May 30, a Missouri state circuit court ruled that Platte County was not required to appropriate funds for the Zona Rosa retail project. It is likely the majority of lease appropriation issuers will continue appropriating funds for lease payments, at least for now. However, this non-payment is an example of a lack of willingness to pay and reinforces the risk inherent in lease appropriation structures.

New Jersey Increases Public Pension Rate of Return

There are actions state and local governments can choose which illustrate they cannot afford their pension obligations—the most notable of which is not paying the actuarially determined amount. Yet, when New Jersey raised its discount rate to 7.50 percent from 7.00 percent in 2018, it should have raised red flags across the municipal bond market. It did not. Forecasts indicated the higher discount rate would save the state $238 million and local governments over $400 million in the near term. Eventually, someone will pay—either the state and local governments or pensioners and bondholders. Choices like this simply add liabilities in the long term and raise questions about an issuer's willingness and ability to pay off its liabilities.

Choices like this simply add liabilities in the long term and raise questions about an issuer's willingness and ability to pay off its liabilities.

Summary

In the past, we could chalk up some news stories regarding the financial strength of state and local governments as mere noise. In the present, we should pay closer attention. The events highlighted above represent significant near-term challenges for the municipal bond market and state and local governments in specific. Even more important is that these events reinforce questions of issuers' willingness and ability to pay. It is likely that similar pressures will result in the development of additional incidents in the near future that market observers and participants should not ignore. Remember, we are beginning the 11th year of the economic expansion. The decisions for state and local governments are only going to get more difficult from here on out, and this will be particularly true when the economy weakens.