Scarsdale Investment Group, Ltd.

All Bond Portfolios

THE CASE of the Unattended Cookie Jar: Public Pensions in Illinois

In good economic times it was easier for politicians to give public unions what they wanted then to deal with the disruption of city services from striking workers. The Unions also provided substantial support to many politicians as well. However, the Detroit bankruptcy highlights all the possible outcomes when tough times come: reduced public services, proposed reduced payment of bond interest (a return on a dollar invested of twenty to fifty cents.) This is called a default. When the dust from Detroit dies down, greater attention will be paid to the state of Illinois debt.

Summary

Illinois completed a $1 billion bond sale at the beginning of February 2014. The Illinois bond sale benefited from improved investor sentiment as a result of a pension system overhaul. Prices of Illinois bonds went up (yields went down) after pension reform passed. However, if the pension reform is declared unconstitutional by a lawsuit starting in June of 2014, prices of the Illinois bonds may go down. Of particular concern are the automatic cost of living increases that the current pension agreements provide. Even if the public employee head count drops, the pension costs may not drop if automatic wage increases for time on the job, called wage drift, and for inflation are not tied to increased productivity.

Pension Issue in Illinois

Illinois passed pension reform at the end of 2013. The key issue is whether a docketed court challenge filed in early 2014, by unions and retirement system participants will succeed in declaring the pension reform law unconstitutional before it takes effect in June, 2014. There are four suits challenging the estimated savings of $145 billion over the next 30 years. The legislation among other things limits cost-of-living increases, caps pensionable salaries, and raises the retirement age for some while cutting employee contributions by 1%.

Arizona, Illinois and New York are the only 3 states with constitutionally mandated protections for state employee pensions. The Arizona Supreme Court unanimously ruled recently that efforts to curb cost-of-living increases for retired judges and elected officials are unconstitutional in Arizona. The sitting politicians would have to vote to change the law, putting their political necks in the guillotine.

Illinois Budget

Illinois closed fiscal 2011 with $82.9 billion of unfunded pension obligations for a funded ratio of 43.4%.

Moody's said that "Illinois' financial condition remains precarious as chronic deficits have led to a budget that is not fiscally sustainable."

A portion of the Illinois income tax increase passed in 2011 will begin to phase out in 2015. The phase out would result in a projected $3 billion deficit.

Illinois has $7.6 billion of unpaid bills from the last fiscal year. The unpaid bills had been $9 billion several years ago.

Ratings

Moody's, S&P and Fitch: All rate Illinois as low single-A rating, down 3 notches in 2013. Fitch and Moody's have a negative outlook for Illinois debt. These are the weakest ratings of any state in the US. The rating agencies are waiting to see how the legal challenge of the pension reform is decided and want to see how the state deals with the looming income tax drop before acting on their ratings.

Chicago

Chicago – in 2015 pensions will consume $1.2 billion of city revenue.

Chicago pension contributions will increase from $476 million in 2012 to $1.2 billion in 2015.

Chicago closed out 2012 with $19 billion in unfunded liabilities across its four pension funds. The pension funds could run out as soon as 2020, or in six years.

Chicago had the highest aggregate unfunded pension burden at more than $18,000 per capita, five times greater than the median of cities examined in a Morningstar report and half as well-funded as even Detroit's.[i]

Chicago is planning to issue $500 million in commercial paper and $900 million in general obligation bonds to refinance debt and improve infrastructure. However, if there is a Chicago bankruptcy, there is no way to know how the bonds will be treated or how the funds will be used.

Conclusion

It is very tempting to reach for higher yields. In more economically stable times, the risk for doing so was quite low. However, we are entering a dicey time because politicians are being asked to deliver on promises that their predecessors made to public employee unions. Politicians and defined benefit plans are a toxic stew that will not be easily cleaned up because public benefits need to be realigned with the available revenues.

In Pennsylvania the adoption of Governmental Accounting Standards Board requirements will require municipalities to report net pension liabilities after June 2014, something they previously were able to avoid.[ii]

To bring pension expenses in line with their budgets, municipalities might eliminate "spiking" overtime, lump-sum payments on retirement, and curtailing pension investment choices. The impact would not be immediate. However, if municipalities choose to borrow, rather than cut their expenses, we can expect ratings downgrades. Realizing that there are more union workers than bond buyers who vote, we suggest you diversify by including out-of-state bonds in your portfolio, and stick with high quality bonds.

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[i] Editorial. "Public Pension Red Alert," *The Wall Street Journal,"* March 8-9, 2014, A12.
[ii] Paul Burton. "Pension Expert: Local Pennsylvania Downgrades Lurk," *The Bond Buyer*, February 27, 2104.

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