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Pension and OPEB Analysis Crucial to Municipal Credit Analysis

Guest Author*: Les Richmond

This is a follow-on piece to Mr. Richmond's July 17th, 2013 article in the Bond Buyer; the below includes updated information and events through the end of 2013.

Two landmark events late in 2013 -- Illinois' adoption of a pension-reform law and a Federal bankruptcy court judge's decision that Detroit pensioners are unsecured creditors who can be "impaired" – cemented the new reality that municipal bond investors need to pay close attention to public employer pensions and other postemployment benefits (OPEB) when evaluating their existing and potential investments.

Illinois is the lowest-rated state, and a key factor in these low ratings is its $100 billion unfunded pension obligation, which is the highest in the nation. Several previous unsuccessful reform efforts led to market uncertainty about whether the pension issue could be addressed short of a crisis, which, in turn, fueled investors' demands for high yields on Illinois bonds.

There are several reasons that Illinois' pension situation is in such dire straits, but the most significant is the State's chronic underfunding of the actuarially determined contribution. The new legislation addresses that shortcoming head-on, setting a goal of full funding of pension liabilities by 2044, and creating mechanisms to force the State to actually contribute the actuarially determined amounts that will be necessary to achieve that goal. By coupling this funding policy with modest benefit reductions, this legislation has a chance to right the pension ship in Illinois. The State was almost immediately rewarded by having to pay less of a yield penalty on its final bond sale of the year.

In the Detroit Chapter 9 case, unfunded pension and OPEB liabilities comprise $9.2 billion ($3.5 billion pension, $5.7 billion OPEB) of the total $18 billion of Detroit's debt. When U.S. Bankruptcy Judge Steven Rhodes ruled that pensions are on a par with other unsecured creditors, in spite of Constitutional protection against pension impairment in Michigan, the news reverberated around the public pension world.

Unlike the Illinois news, however, where the market reaction was swift and positive, it will take longer to fully assess the impact of the Detroit ruling. On a positive note, this means that bond insurers and other creditors will suffer lower losses during Detroit's reorganization than without pension impairment. However, it leaves open the question of whether it will make bankruptcy a more attractive option for other governments with excessive pension burdens.

That means that analyzing the funding of public pensions and OPEBs must continue to be a crucial step in any assessment of municipal creditworthiness. At Build America Mutual (BAM), we incorporate actuarial analyses of pension and OPEB liabilities into our review of every municipal bond we consider insuring. We look at both the steps governments are taking to address shortfalls in funding, and metrics we have developed, based on actuarial calculations. Our ultimate credit decision many times rests on the results of our pension and OPEB analysis, which includes not just an assessment of their current funding status, but also a review of the steps a government is taking to address it.

Can underfunded pension funds catch up? What are governments doing to confront the pension and OPEB underfunding issue?

In order to close a funding gap, an employer can take steps to increase plan assets, decrease plan liabilities, or a combination of the two.

With respect to increasing plan assets, some employers are updating their funding policies to result in higher annual plan contributions. For example, the State of New Jersey has legislated a seven-year phased-in approach to funding the full actuarially determined pension contribution. Many governments are updating their actuarial assumptions, and notably, over the past several years there has been a trend towards adopting a lower investment rate of return assumption. This step increases the liability (and the actuarially determined contribution) in the short term, but it reduces the risk of investment-earnings shortfalls that could hurt the plan's funding status down the road.

There are two basic approaches being used to reduce public sector pension and OPEB plan liabilities: Cost shifting in which an employer shifts plan costs to another government or to employees; and plan design changes that change the ultimate benefits payable under the plan – who is eligible to receive benefits, how much they will be paid, and when. Though historically rare, there is a growing trend in proposing and implementing changes that affect the benefits of current employees and retirees. For example, some California mayors, led by San Jose Mayor Chuck Reed, are pushing for legislation that would allow changes to be made to prospective pension accruals for existing employees.

How does BAM analyze pension and OPEB obligations? How do these obligations affect municipal credit analyses?

In our qualitative analysis, we take note of actions by governments, such as those described above, to determine whether the government is taking steps to confront the underfunding issue. We monitor the status of pension and OPEB reforms, and make judgments on whether we believe they adequately address the issuer's underfunding on a long-term basis. We take into account currently effective reforms, and the likelihood that additional proposed reforms will be enacted into law, based on such considerations as statutory, contractual or constitutional protections of benefits. We also review the asset allocation of the pension and OPEB funds to see whether the funds are invested in risky asset classes, which could make the plan more prone to large investment losses in the case of another market downturn.

Quantitatively, it is important that the way we analyze the impact of pensions and OPEBs on a government's creditworthiness be based on the fundamental principles of comparability and conservatism. The liabilities and cash requirements currently disclosed by governments in their audited financial statements are neither (rather, they are based on varying actuarial assumptions and methods that have tended to be quite aggressive). Therefore, we have adopted an approach to "normalize" both the unfunded benefit liabilities and the funding contributions.

This normalization includes use of: a standard investment rate of return assumption for liabilities (although the standard assumption is different for funded and unfunded plans); standard adjustment factors to convert liabilities and normal costs away from the return assumption used by the system actuary; market value of assets (as opposed to a smoothing approach); level dollar amortization of unfunded liabilities over a reasonable time period; and, minimum healthcare cost trend rates for OPEB liabilities.

The discount rate we have chosen for funded plans is 6%, and is based on a reasonable long-term expectation of investment returns on an average portfolio of plan assets, with a downward adjustment for conservatism. (Most public sector pension plans are valued using an investment return assumption of 7% to 8%.) Using a conservative long-term investment return assumption has an additional advantage in that it allows for comparisons across time periods, since this assumption would only be changed if emerging experience indicates that a new long-term assumption is warranted.

Once normalized unfunded liabilities and contributions have been calculated, they can be used in determining various ratios that indicate whether a government is carrying an excessive debt burden, and whether cash funding requirements are sustainable over the long-term (especially over the duration of the bond we are considering for insurance). Finally, the metrics we calculate based on normalized pension and OPEB data will not be fully comparable to generally available benchmarking data that exists for credit rating purposes. Therefore, we compare our metrics to a growing, internally-developed database geographically or by sector (i.e., cities, school districts, municipal authorities, etc.). Based on these comparisons, we can determine which governments appear to be carrying significant debt or cashflow burdens relative to others within a BAM-internal rating category, which in turn may have an impact on their overall credit rating result.

Conclusion

In conclusion, pension and OPEB obligations are an important factor BAM considers when we analyze the creditworthiness of municipal bonds for our guaranty. Our approach is to carefully consider these obligations from a comparable, conservative quantitative perspective, and also a qualitative perspective. The quantitative analysis provides us an understanding of the current state of the pension and OPEB burden. Though our quantitative analysis alone may indicate that some concern is warranted, the qualitative analysis may indicate that a government is taking the steps necessary to confront the challenge of underfunding.

Finally, we put our pension and OPEB analysis into the context of the overall credit analysis of the bond issuer. For example, there may be other government programs, such as state aid intercept programs, that provide a cushion against excessive debt burdens or budget strains. We may find that when combined with the government's other debt burdens, the pension and OPEB liabilities may be manageable, even if on a stand-alone basis these liabilities seem high.

Author Bio: *Les Richmond, Vice President and Actuary for Build America Mutual, evaluates pension and OPEB liabilities of the municipal entities BAM guarantees. He is an Associate of the Society of Actuaries and an Enrolled Actuary. He is also a member of the American Academy of Actuaries, Fellow of the Conference of Consulting Actuaries and a member of the American Society of Pension Professionals and Actuaries. He holds a B.A. in Mathematics from Rutgers College.*

**The information, opinions, and recommendations presented by guest authors do not necessarily reflect the views of Ipreo. Statements and opinions expressed in articles, reviews and other materials herein are those of the article's author.*

Municipal Bond League Tables for 2013

Top Lead Managers

Rank	Lead Manager Parents	Market Share	Par Amount (US$ mil)	# of Issues	# of Issuers
1	BA Merrill Lynch	14.71	46,228.26	325	250
2	JPMorgan	13.03	40,936.35	274	208
3	Citigroup	11.13	34,968.40	277	230
4	Morgan Stanley	6.17	19,384.59	199	160
5	Wells Fargo Secs	5.53	17,388.76	185	143
6	RBC Capital Mkts	5.51	17,327.44	488	406
7	Barclays Capital	5.22	16,388.00	89	78
8	Goldman Sachs	4.92	15,458.17	54	47
9	Piper Jaffray	3.70	11,630.89	604	535
10	Raymond James	3.09	9,703.87	452	404
11	Robert W. Baird	2.67	8,386.61	798	688
12	Stifel Nicolaus	2.50	7,848.09	465	417
13	Jefferies	1.43	4,506.42	60	55
14	Loop Capital	1.12	3,522.29	24	17
15	Siebert Brandford	1.07	3,369.44	15	15
16	BOSC	0.88	2,764.50	366	331
17	George K. Baum	0.83	2,618.99	150	130
18	Hutchinson Shockey	0.77	2,434.19	223	166
19	Samuel A. Ramirez	0.75	2,360.42	16	13
20	Janney Montgomery	0.74	2,325.42	185	169
21	PNC Capital Markets	0.69	2,159.35	138	132
22	D.A. Davidson	0.65	2,032.88	355	299
23	Guggenheim Secs	0.65	2,029.93	21	20
24	Roosevelt & Cross	0.62	1,935.16	366	340
25	De La Rosa & Co	0.59	1,854.87	59	53
Top 25 Total		88.97	279,563.29	6,188	4,542
Total All		100.00	314,235.19	10,008	7404

Top Financial Advisors

Rank	Financial Advisor Parents	Market Share	Par Amount (US$ mil)	# of Issues	# of Issuers
1	Public Fin Mgmt	22.48	54,722.97	731	498
2	Public Resources	15.52	37,785.38	106	45
3	FirstSouthwest	10.07	24,517.07	621	438
4	Acacia Fin Group	4.64	11,283.08	92	51
5	Lamont Financial	3.82	9,294.17	38	14
6	A.C. Advisory	3.81	9,272.96	25	7
7	Estrada Hinojosa	3.01	7,336.00	62	36
8	Piper Jaffray	2.96	7,196.37	194	131
9	KNN Public Finance	2.15	5,229.11	48	37
10	RBC Capital Mkts	1.93	4,703.75	144	122
11	Swap Financial	1.92	4,683.73	9	2
12	Montague DeRose	1.88	4,568.20	23	8
13	Davenport	1.45	3,524.59	73	54
14	Kaufman Hall	1.36	3,311.51	30	18
15	Raymond James	1.34	3,252.41	80	56
16	Fieldman Rolapp	1.20	2,913.20	68	58
17	Southwest Securities	1.19	2,897.78	182	152
18	Frasca & Associates	1.11	2,706.54	6	4
19	Drexel Hamilton	0.95	2,301.55	7	1
20	Ponder	0.88	2,153.55	22	13
21	Prager & Co	0.86	2,083.45	11	9
22	CSG Advisors	0.81	1,978.41	40	19
23	Columbia Cap Mgmt	0.78	1,894.20	39	20
24	BOSC	0.76	1,850.54	59	43
25	Peralta Garcia	0.76	1,838.46	5	3
Top 25 Total		74.90	182,316.45	2,614	1,743
Total All		100.00	243,397.07	6,608	4854

Municipal Bond League Tables

Top Issuers

Rank	Issuers	Market Share	Par Amount (US$ mil)	# of Issues
1	State of California (CA)	2.69	8,449.60	11
2	City of New York	1.60	5,015.76	13
3	The Regents of the University of California	1.50	4,702.07	9
4	State of Illinois	1.07	3,354.11	6
5	The Commonwealth of Massachusetts (MA)	1.03	3,225.85	8
6	Dormitory Authority of the State of New York (NY)	0.96	3,031.31	16
7	New Jersey Economic Development Authority (NJ)	0.96	3,018.36	7
8	New York City Transitional Finance Authority (NY)	0.96	3,016.31	7
9	State of Washington	0.93	2,936.44	14
10	Grand Parkway Transportation Corporation (TX)	0.93	2,920.07	1
11	State of Connecticut (CT)	0.87	2,736.90	10
12	Empire State Development Corporation (NY)	0.78	2,439.37	6
13	Metropolitan Transportation Authority (NY)	0.74	2,333.79	5
14	New York City Municipal Water Finance Authority	0.73	2,301.55	7
15	Foothill / Eastern Transportation Corridor Agency	0.72	2,274.62	2
16	New Jersey Turnpike Authority	0.68	2,136.88	3
17	Cities of Dallas and Fort Worth	0.66	2,066.89	7
18	Utility Debt Securitization Authority (NY)	0.64	2,022.32	2
19	Florida Hurricane Catastrophe Fund Finance Corporation	0.64	2,000.00	1
20	State Public Works Board of the State of California	0.61	1,912.16	4
21	Port Authority of New York and New Jersey	0.59	1,850.00	2
22	South Carolina Public Service Authority	0.59	1,848.15	4
23	New York State Thruway Authority	0.58	1,831.00	2
24	State of Ohio (OH)	0.58	1,809.90	30
25	Jefferson County (AL)	0.57	1,785.49	1
Top 25 Total		22.60	71,018.86	178
Total All		100.00	314,272.65	10,010

Top Bond Counsels

Rank	Bond Counsel Parents	Market Share	Par Amount (US$ mil)	# of Issues	# of Issuers
1	Orrick, Herrington & Sutcliffe	10.93	34,232.54	286	194
2	Hawkins, Delafield & Wood	6.95	21,789.53	270	189
3	Squire Sanders (US) LLP	4.81	15,056.11	174	139
4	Kutak Rock	4.30	13,481.78	242	156
5	Fulbright & Jaworski	4.04	12,669.04	312	208
6	McCall Parkhurst & Horton	3.83	12,003.69	317	225
7	Stradling, Yocca, Carlson & Rauth	3.12	9,786.57	149	129
8	Nixon Peabody LLP	2.45	7,661.21	64	38
9	Bracewell & Giuliani LLP	2.29	7,187.09	112	66
10	Sidley Austin LLP	1.98	6,194.12	27	13
11	Gilmore & Bell	1.76	5,528.79	488	377
12	Foster Pepper PLLC	1.62	5,087.74	97	69
13	Edwards Wildman Palmer LLP	1.52	4,772.54	203	152
14	Wolff & Samson	1.49	4,676.65	20	8
15	Peck, Shaffer & Williams	1.47	4,612.86	162	132
16	Andrews Kurth LLP	1.35	4,221.10	79	62
17	Chapman and Cutler	1.30	4,081.41	259	226
18	Mayer Brown LLP	1.26	3,941.77	9	4
19	Quarles & Brady	1.21	3,799.40	397	272
20	McCarter & English	1.20	3,749.59	18	11
21	Sherman & Howard L.L.C.	1.18	3,700.69	76	53
22	Mintz, Levin, Cohn, Ferris, Glovsky & Popeo, P.C.	1.16	3,632.36	21	9
23	Greenberg Traurig, LLP	1.05	3,296.49	61	48
24	Nabors, Giblin & Nickerson	1.05	3,293.84	35	30
25	Dorsey & Whitney	1.03	3,218.56	282	198
Top 25 Total		62.68	196,388.24	4,139	2,902
Total All		100.00	313,322.26	9,947	7355

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Ipreo Annual "Volume Visionary" Contest

Prove your muni market expertise by predicting municipal volume for the month of March 2014. Submit your prediction to muniIC@ipreo.com by **February 26th**.

The person who comes closest to the actual volume number will win an iPad, courtesy of Ipreo. Please include your prediction for the number of issues in case a tiebreaker is needed. The winner will be contacted by email and annouced in the next issue of MuniIC!

RAISE YOUR VOICE!!
MuniIC Wants to Hear From You

Agree or disagree? Ideas? Comments? The MuniIC team would like to hear what you have to say on the topics presented in this newsletter. We welcome your feedback on all of the articles and topics presented in this newsletter.

Please send all comments to: MuniIC@ipreo.com

(NOTE: All comments may be published or excerpted in the next issue unless otherwise requested by the submitter.)

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Featured Investor Snapshot

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Thornburg Investment Management, Inc.

Santa Fe

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Fax: +1 505-992-8681

Portfolio Stats	
Fixed Income Assets ($mm)	14,865.4
Total Reported Assets ($mm)	69,732.2
Institution Type	Investment Advisor-Mutual Fund
# of FI Securities	3,768

Thornburg Investment Management, Inc (Thornburg) invests in a) U.S. municipal bonds rated BBB to AAA across all maturities; b) U.S. treasury bonds with maturities ranging from 1 to 10 years; c) global corporate bonds rated D to AAA across all maturities, primarily focusing on North America and Europe; and d) U.S. ABS, agency MBS, and CMOs rated D to AAA across all maturities
The firm uses laddered portfolios seeking to obtain a high level of income while preserving principal. Thornburg benchmarks against the Barclays Capital Municipal Bond Index and the Barclays Capital U.S. Universal Blended Index.

Contacts

Name	Role	Phone Number
Mr. George T. Strickland	Portfolio Manager	+1 505-984-0200
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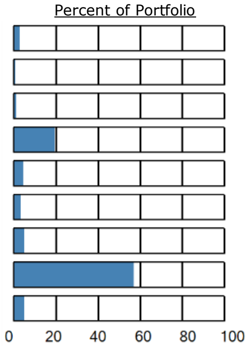
Strickland is a managing director and portfolio manager at Thornburg Investment Management, Inc.. He joined the firm in 1991. Previously, Strickland worked with Calvert Group.

He received a BA in Economics from Davidson College and a MBA in Finance from the University of Maryland.

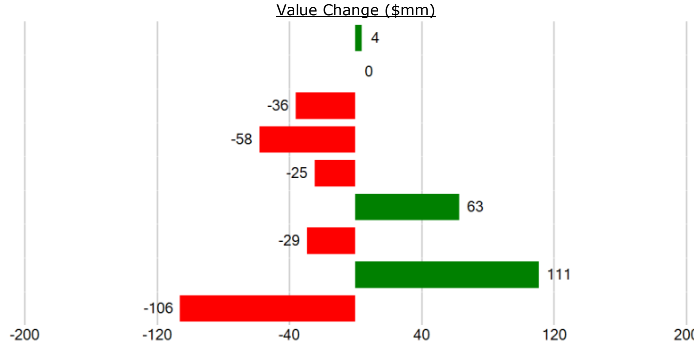
Fixed Income Market Sector

Market Sector	Value ($mm)
ABS	430.7
Convertible Preferred	137.2
Convertibles	164.6
Corporate	2,920.9
Fixed Income - Other	697.3
Government	505.5
MBS	749.8
Municipal Bonds	8,484.0
Preferred	775.6

Percent of Portfolio



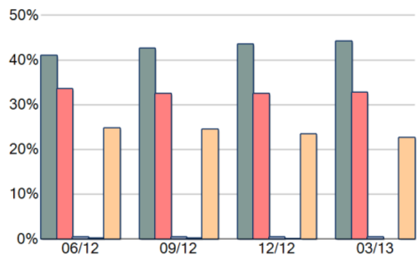
Value Change ($mm)



Allocation in Municipal Debt

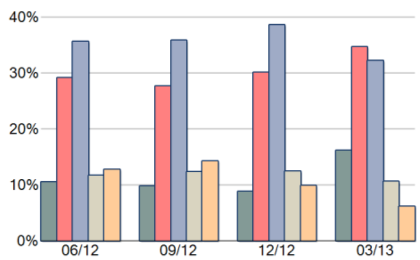
Municipal Rating Breakdown

Rating	Val ($mm)
AAA-AA	3,751.8
A-BBB	2,775.5
BB-B	30.3
Other	1,926.4



Municipal Maturity Breakdown

Time to Maturity	Val ($mm)
Maturing in < 1 Yr	1,374.7
Maturing in 1-5 Yrs	2,941.7
Maturing in 5-10 Yrs	2,738.0
Maturing in 10-20 Yrs	902.0
Maturing after 20 Yrs	527.6

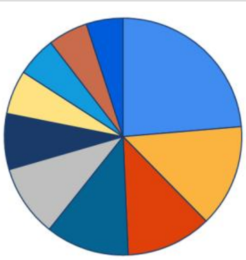


Municipal Use of Proceeds Breakdown

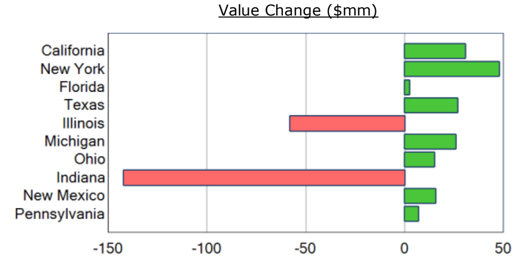
Use of Proceed	Val ($mm)	Chg ($mm)	% Port
General Purpose/Public Improvements	1,686.1	90.8	19.87
Education	1,302.6	162.5	15.35
Health Care	742.1	8.2	8.75
Utilities	482.0	-66.1	5.68
Water & Sewer	320.1	12.0	3.77
Transportation	311.4	12.0	3.67
Public Safety	194.0	11.0	2.29
Economic Development	141.6	-4.6	1.67
Pollution Control	118.8	5.6	1.40
Housing	87.9	-3.7	1.04
Recreation	60.2	9.0	0.71
Sanitation	30.7	0.0	0.36
Industrial Development	26.3	0.0	0.31
Pension/Retirement/Disability	4.8	0.0	0.06

Top 10 Municipals By Issuer State

State:	Val ($mm)
California	1,209.5
New York	716.4
Florida	596.6
Texas	582.2
Illinois	502.4
Michigan	390.5
Ohio	307.2
Indiana	277.8
New Mexico	277.8
Pennsylvania	256.4



Value Change ($mm)



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