Municipal Market Comments

ASCENT Investment Partners

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from Montage Investments

Pensions Continue to Apply Credit Pressure: Moody's Criteria and CalPERS Policy Threaten Ratings

On April 16, the California Public Employees' Retirement System (CalPERS) proposed changes that could result in increases of 50% to the amounts that local governments in California must contribute annually for pensions. The following day, Moody's announced revisions to how it analyzes public pensions and placed the ratings of 29 local government issuers under review. Moody's criteria change, focused on the size of unfunded pension liabilities relative to the overall size of the budget, triggered a review mostly of very highly rated issuers in the Midwest, Great Lakes and Southwest regions, including:

- Chicago, IL (G.O. ratings Aa3/A+)
- Cincinnati, OH (Aa1/AA+)
- Minneapolis, MN (Aaa/AAA)
- Portland, OR (Aaa/nr)
- Santa Fe, NM (Aa2/AA)

Interestingly, none of the issuers under Moody's review is located in California. The majority are school districts in Ohio and Michigan or cities, counties and towns in New Mexico, Minnesota, Illinois and Nevada. None is considered to be in fiscal distress or budgetary crisis; the weakest is rated 'A1' and many are rated 'Aaa.'

Funding for retiree pension and health care costs is a large and growing problem for some state and local governments. Pension funding pressures have contributed to downgrades of the ratings of Illinois and Puerto Rico in recent months, and retiree costs were a significant driver in the bankruptcy filings of the California cities of Stockton and San Bernardino. Even so, the vast majority of municipal issuers do not face undue budget pressure from costs associated with retirees. While there are certain geographic areas or market sectors that may be more or less likely to face pension pressures, issuers must always be evaluated individually.

At Ascent, pension funding practices are one of the factors we evaluate in our credit process. Prudent management of retiree liabilities is an indication of responsible financial management and is generally reflected in high credit ratings. Even so, issuers with high credit quality can face budget pressures, as evidenced by Moody's recent review.

However, financially strong issuers are the best positioned to make changes to pension funding practices and implement the policies needed to stabilize budgets over the long term. Lower-rated issuers present a much higher degree of credit and market risk for investors since they are more likely to have less flexibility in dealing with unexpected policy shocks, such as pension funding changes or revisions to rating agency criteria.

Moody's rating action comes out of a revision to the way that agency evaluates pension liabilities for state and local governments. Moody's new criteria compare unfunded pension liabilities after adjusting pension data reported by issuers. Moody's adjustments use discount rates that it believes more accurately reflect the real-world investment environment faced by issuers over the long term. Moody's adjusted liabilities are then measured as a percentage of the overall size of the issuer's budget and compared to medians for comparably-rated issuers. Any issuer falling far outside the median range for its rating category was placed under review.

We expect that Moody's will engage each of these issuers in discussions about how they plan to address their pension funding situations. Some issuers, such as Chicago, have been thoroughly discussed in the media and their pension funding issues will likely only be managed through a long and highly political process. Others issuers, particularly smaller cities, may have much more flexibility to make meaningful changes in the near term that may address Moody's concerns and result in affirmation of the current ratings. Moody's did state in its rating release that the potential impact of any downgrade for any issuer is expected to be limited to no more than two notches (e.g., an issuer rated Aa2 could drop as low as A1). Our initial review suggests that the issuers at the greatest risk of downgrade appear to be the cities of Santa Fe, NM (Aa2/AA); Virginia, MN (A2/A+); Las Vegas, NM (A1/nr); and Chicago, IL (Aa3/A+). We will continue to monitor this situation and revise our credit evaluations of individual issuers as warranted.

In California, CalPERS proposed changes to the way it calculates pension contributions from participating municipalities. The increased contribution levels would be phased in over five years. CalPERS change was driven by a drop in its funding level that occurred as the result of growing retiree obligations combined with poor investment performance during the financial crisis and recession. While CalPERS' move is a responsible one from a pension management perspective, it raises a host of issues for participating municipalities, which are certain to face increased pension costs in the near term and will likely be forced to deal with greater volatility in annual contribution rates over the longer term. We will continue to evaluate individual issuers in light of CalPERS' changes and limit clients' exposure to pension-driven credit risk.

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