Gurtin Municipal Bond Management

Municipal Credit Update

Does Harvey, Illinois, Spell Trouble for Municipal Bond Investors?

June 2018

Executive Summary

Illinois and pensions are again dominating the municipal bond market's attention after the Illinois state comptroller impounded state-shared revenues from the city of Harvey, Illinois (the City), with the intention of diverting them to the City's underfunded police and fire pension plans. These actions have stoked anxiety among municipal bond investors who question what this means for other Illinois cities and whether obligors' pension funds enjoy a superior claim on a city's revenues over bondholders.

Underfunded pensions and escalating annual pension contributions will likely remain a credit concern across the nation, as these costs have the potential to crowd out other spending priorities; however, mechanisms that ensure funding discipline, such as those Illinois has imposed, have the potential to actually strengthen credit quality for some obligors.

In this update, we explain the factors prompting considerable uncertainty surrounding the law that the comptroller is employing in order to divert state-shared revenues toward underfunded pension plans as well as address the heightened credit risk it may impose on some obligors. An analysis of the Illinois municipalities we hold in client portfolios shows why we do not anticipate the pension intercept law will materially affect our clients' holdings. Furthermore, our portfolio management team believes that fears about *all* Illinois debt create opportunities to capture additional spread in certain high-quality obligor-securities mistakenly caught in the fray.

What the New Mechanism Means for Municipal Bondholders

The courts have yet to issue a decision regarding whether pensioners have priority over general obligation bondholders; and, apparently, even pension plans and obligors are uncertain about what the statute actually means for them.

History of the Pension Intercept Law

The state of Illinois comptroller's office began withholding certain state-shared revenues of the city of Harvey in February 2018. The comptroller's actions were driven by a law passed in 2011 that became fully effective in 2016 and applies to more than 650 locally administered police and fire pension plans in Illinois. It allows a police or fire pension board that received less than the minimally required annual contribution from a municipality to notify the comptroller's office, which is then directed to withhold the deficient amount from state-shared revenues until the contribution is fully funded. Under state law, local police and fire plans must be 90% funded by 2040; however, until the law was enacted, there was no mechanism to compel compliance with contribution requirements.[1]

Uncertainty Surrounding the Priority of the General Obligation Pledge

Harvey has defaulted on its general obligation bonds multiple times.[2] However, based on publicly available information, it appears each default was cured in a relatively short period — so there were no legal proceedings during which general obligation bondholders pressed their claim in direct opposition to the pension funds.

All that has been decided is the state comptroller has the power and duty to withhold state-shared revenues in favor of the pension funds. Only after that claim has been satisfied can residual shared revenues flow to the city. [3]

Some infer this directly impairs general obligation bondholders, given both the Illinois state comptroller's diversion of state-shared revenue funds in the name of the Pension Intercept Law and previous historic rulings on attempted pension reform, which have made clear the almost unassailable position of Illinois pensioners. However, all court orders thus far have been silent on the priority of the general obligation pledge. For the moment, we would describe pensioners as enjoying a privileged position; however, without legal precedent, we would not go so far as to say they have primacy over municipal general obligation bondholders.

Gurtin Client Holdings: Well Positioned

Some news reports[4] suggest the new law could send a tidal wave of obligors careening toward insolvency. Inspection of the Illinois Department of Insurance's

[1] Local Illinois pension funding woes raise credit concerns. Reuters. May 3, 2018. https://www.reuters.com/article/illinois-moodys/local-illinois-pension-funding-woes-raise-credit-concerns-idUSL1N1SA1QB

[2] Harvey, Illinois Comprehensive Audited Financial Statements.

[3] Local Illinois pension funding woes raise credit concerns. Reuters. May 3, 2018. https://www.reuters.com/article/illinois-moodys/local-illinois-pension-funding-woes-raise-credit-concerns-idUSL1N1SA1QB

[4] Farmer, Liz. The Week in Public Finance: This Illinois Town Is on the Brink of Bankruptcy. How Many Will Follow? Governing. May 18, 2018.

calculations does show many pension funds are at risk of the comptroller withholding revenues due to contribution shortfalls. However, a sense of proportion needs to be recognized by asking, "How large is the potential garnishment, and does the obligor have the resources to cope?"

Following a thorough review of Illinois municipal obligors held in our clients' portfolios, we believe these holdings are strong enough to manage any revenue withholdings the comptroller may impose.

Credit Risk for Some Obligors, Benefits for Others

By enforcing contributory discipline, the law has the effect of removing revenues from an obligor's budget. For the subset of obligors that have a large gap between what they are required to contribute to their pensions and what they have contributed, the impact could add immediate financial pressure. Additionally, if an obligor has limited financial flexibility and is already confronting distress, as is the case with Harvey, any lost revenue could push it toward insolvency.

For healthy obligors — including those that only have a modest gap between their required and actual pension contributions and that enjoy a high degree of flexibility — the law could actually be a long-term net positive by preventing modest shortfalls from developing into larger and more difficult-to-manage contributions. The actual withholding of revenues on those governments able to accommodate required contributions, or the threat of garnishment to others, could prevent more cities from facing a similar downfall as Harvey's in the future by provoking responsible pension-funding choices.

However, it is important to recognize that compliance with statutorily required contributions can still result in growing unfunded pension liabilities. For example, this can happen when the pension plan uses aggressive investment targets to calculate its annual contribution and comes short on meeting those targets.

For this reason, in our analysis of municipalities' pension plans, we don't simply rely on whether a municipality is meeting statutorily set pension contributions. We also look at actuarially determined

Figure 1. Median Data Comparison

	Median Tax Base Size (Full Value) (in Millions)	Median Family Income as a % of the U.S. Average	Median General Fund Balance as a % of Revenues[5]
Gurtin Municipal Bond Management – Illinois Medians	$2,588	145.1%	51.0%
Moody's National Medians[6]	$1,867	112.6%	33.9%
City of Harvey, Illinois	$596	53.5%	-228.5%

[5]Gurtin's general fund revenues do not include transfers.
[6]Moody's Medians- Property Values Key To Stability But Pension Burden Remain A Challenge March 30, 2018

contributions and a full picture of the assumptions used by the plan, plus the size of its unfunded liabilities relative to the municipality's resources and financial flexibility.

An Analysis of Gurtin Client Portfolios: Stronger, Larger, Wealthier

On balance, our clients' Illinois holdings are larger, wealthier, and have a stronger balance sheet compared to national medians, as shown by our thorough survey using data derived from a review of Illinois municipal holdings in our clients' portfolios (see Figure 1). Additionally, we believe our clients' Illinois holdings would be exposed to only modest and manageable revenue garnishments should it occur.

One-third of our clients' holdings overfunded both police and fire pensions, based on the 2016 Department of Illinois Insurance figures[7] on police and fire pensions — in many cases, a city is not responsible for a fire pension, as that is covered by a separate and independent fire district.

Of those remaining obligors, the median net shortfall (if one pension was underfunded and one overfunded) was a negligible 0.04% of General Fund revenues. [8] Taking an extremely conservative approach and simply looking at any fund that was underfunded, and ignoring the presence of an overfunded pension, the median gross shortfall of our clients' holdings is still a very small 1.0% of General Fund revenues.

Furthermore, the median funded ratios[9] (using the department's figures) for the obligors in our clients' portfolios of 63.3% for police and 64.4% for fire, is above statewide medians of 57.2% and 60.3%, respectively. (Note: The fire figures include independent fire districts.)

In addition to having only modest exposure to potential garnishment, we believe our clients' Illinois holdings have very strong overall credit profiles. After all, the key question is how easily an obligor can manage through the current and expected future environment.

Almost all of our clients' Illinois municipal holdings are "Home Rule" municipalities, which vests the government with unlimited property tax authority, no statutory debt ceiling, and the ability to impose a broader range of taxes – such as an additional sales tax, food and beverage tax, hotel tax, real estate transfer tax, amusement tax, etc. Given that our clients' Illinois holdings have sizable cash reserves, we believe they have sufficient tools to navigate whatever actions the comptroller may take.

Fears over All Illinois Debt Create Opportunities for Additional Spread

In addition to weathering the potential garnishments from the new statute, high-quality obligors in the state of Illinois may offer municipal bond investors opportunities to gain spread in today's market. The municipal market appears to be painting many Illinois obligors with a fairly broad brush, ignoring the credit

[7] Illinois Department of Insurance, retrieved from https://insurance2.illinois.gov/Applications/Pension/FOIAReporting/FOIAPortal.aspx

[8] Illinois Department of Insurance, retrieved from https://insurance2.illinois.gov/Applications/Pension/FOIAReporting/FOIAPortal.aspx and Comprehensive Audited Financial Statements

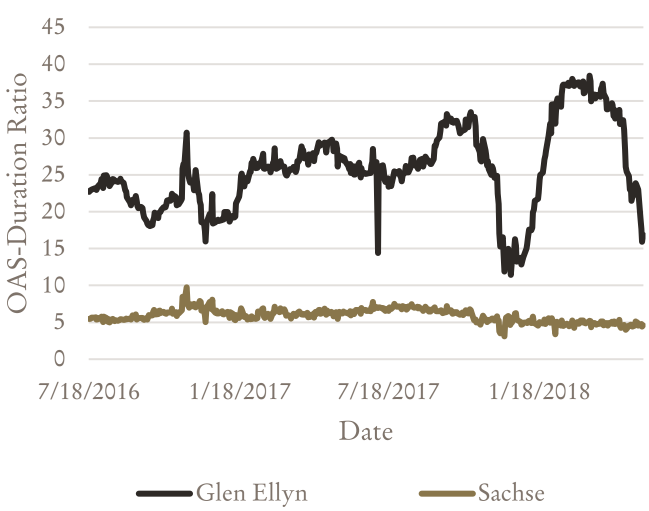
[9] The funded ratio represents a pension plan's assets divided by its estimated future liabilities.

quality of many solid local obligors that are well insulated from problems both at the state level and at the city level such as those issues plaguing cities such as Harvey. As a result, our portfolio management team has located opportunities in which strong obligor-securities are trading at what it believes are cheap levels, given the structure of the bonds and the credit quality of the obligor.

Figure 2 illustrates the value that strong credit selection working in tandem with portfolio management can have in finding value for our clients. It shows the option-adjusted spread/effective duration ratios for the city of Glen Ellyn, Illinois, and the city of Sachse, Texas, going back to July 2016.

OAS provides the spread a bond offers above AAA rated securities while properly accounting for embedded options, thereby giving a measure of the additional compensation an investor receives due to credit and liquidity factors. However, it is difficult to directly compare the OAS of bonds with differing effective durations, as we generally expect bonds with longer durations to have higher spreads. The OAS-duration ratio seeks to remedy these OAS comparisons by normalizing by effective duration.[10]

Figure 2. Glen Ellyn, IL/Sachse, TX Historical OAS-Duration Ratio



By comparing Glen Ellyn to a similarly rated Texas city — which has no state income tax, and thus has not seen its pricing levels skewed by aggressive in-state demand the way many California and New York obligors have — we believe you can see the value that exists in Illinois. Glen Ellyn, despite having a very strong credit profile, has routinely had an option-adjusted spread normalized for duration of four to five times that of Sachse. There have been periods of volatility, especially during the tax reform debate in December 2017 when Glen Ellyn's OAS-duration ratio declined significantly; however, we believe the chart shows a prolonged opportunity to find additional spread for clients.

Without taking on any meaningful additional credit risk, we believe our portfolio management team can find opportunities such as Glen Ellyn where we would suggest the market may be mis-pricing bonds due to generalized fear and anxiety generated by Illinois' well-publicized challenges.

What Happened with Harvey?

In contrast to the strong credit profiles of Illinois obligors held in our clients' portfolios, the city of Harvey has been struggling financially for decades, in

[10] Option Adjusted Spread measures the additional compensation an investor of a bond is receiving due to credit and liquidity factors. It is calculated using backward propagation along an interest rate tree, which is derived from a one-factor model calibrated to either the option-free muni curve or Treasury curve as well as a historical volatility curve.

addition to falling significantly behind in making regular contributions to its pension systems, which led a court to determine the funds were "on the verge of default."[11] It has faced SEC violations for misleading investors on the use bond proceeds, struggled to produce regular financial audits, and defaulted periodically on general obligation bond payments starting in 2015.[12]

Harvey's situation is decidedly more severe than most; however, it is not the only city that may face a state fund intercept. Subsequent to Harvey's filing, the city of North Chicago saw its funds subject to the intercept, and various other cities may follow in their wake, leaving investors to wonder how their other Illinois holdings may be affected.[13]

Where the Pension Intercept Law Stands

Police Pension Plans, Fire Pension Plans, and Bondholders Fight for Funds

This fluid situation involves various stakeholders who are arguing their legal standing in a Cook County circuit court. For the moment, though the comptroller has withheld city funds, no disbursements to the pension plans have been made.

Representatives for the police pension plan argue that it should be paid ahead of the fire pension plan when funds are disbursed because they filed their claim first. Lawyers for the fire pension fund said the law is vague at this point, commenting, "We are making this up as we go along" because the statute "doesn't really cover the situation as well as it should."[14]

Meanwhile, bondholders for Harvey's 2008 sales/hotel tax-backed bonds asserted their own legal standing on withheld revenues, with the court recently ruling revenue bondholder's claim on the city's home rule sales tax should be paid ahead of the pension funds. However, it is important to note that the decision was made on the basis that the home rule sales tax was outside the statutory boundaries of what the comptroller could intercept (i.e., a distinction was made between the state-shared sales tax and home rule sales tax). The court did not rule on the basis of recognizing a bondholder's superior right.[15]

Ambiguity about the Recognized Pension Requirement

Our discussions with the comptroller's office and municipalities have revealed an uncertainty regarding what the recognized pension requirement would be. Most of the reporting on this matter has utilized the State's department of insurance calculations of the required contribution. However, individual municipalities often use their own independent actuarial analysis and set of assumptions, which can differ from the State's. The statute recognizes either as a valid basis to determine the requirement.

In some cases, required contributions can vary materially. The comptroller does not decide what the

[11] Moody's Investors Service "Harvey court ruling highlights Illinois' pension protections." February 7, 2018.

[12] Shields, Yvette. Harvey, Illinois Leaves Bondholders Empty-Handed. April 29, 2016. https://www.bondbuyer.com/news/harvey-illinois-leaves-bondholders-empty-handed

[13] Minnis, Glenn. North Chicago joins Harvey in being crippled by pension crisis. Lake County Gazette. April 19, 2018. https://lakecountygazette.com/stories/511395600-north-chicago-joins-harvey-in-being-crippled-by-pension-crisis

[14] Shields, Yvette. Harvey pins hopes on settlement to resolve pension intercept dispute. The Bond Buyer. May 18, 2018. https://www.bondbuyer.com/news/harvey-illinois-wants-to-settle-pension-intercept-dispute

[15] Shields, Yvette. A narrow win for bondholders still sets an ominous precedent in Illinois. The Bond Buyer. May 22, 2018. https://www.bondbuyer.com/news/illinois-comptroller-makes-a-split-pension-intercept-ruling

correct amount is; they simply act when a pension board certifies a deficiency. There is a 60-day protest period during which a municipality can argue for a different contribution requirement, but there is nothing specified as to what would guide a court in determining compliance with the statue if a dispute arose between a municipality and pension board. Illinois lacks a bankruptcy process; in its absence or codified law, a decidedly unclear picture will likely persist.

A Strong Credit Selection Process Protects Against Pension Risk

We do not yet have certainty on some key features of the Illinois pension intercept statute, and we anticipate the landscape may continue to evolve. As the fallout from Harvey continues, we believe it is possible that the Illinois legislature will look to tweak the implementation of the statute as it recognizes that it may be pushing a number of distressed obligors toward service defaults and/or insolvency and as the comptroller's office receives feedback from both pension plans and municipalities.

The Illinois pension statute is not unique. A number of solidly funded pension plans use various mechanisms to ensure funding discipline, including Missouri's Local Government Employees Retirement System (LAGERS), Illinois' well-funded Municipal Retirement Fund (IMRF), and Idaho's public pension plans. Additionally, Texas has pension payment mandates in its state constitution.[16]

Beyond just Illinois, public pensions will remain a major credit concern for municipal obligors for the foreseeable future. Even after a prolonged bull equity market that has boosted investment returns, many public pension plans continue to demand higher annual contributions from municipal obligors. Budgetary stress from pensions will only be exacerbated when markets decline.

As we believe the Illinois example demonstrates, municipal investors' best defense is a strong credit selection process that seeks to invest only in obligors with credit profiles that can withstand whatever pension-related challenges lie ahead. Despite the headlines and anxiety, we believe there are high-quality obligors in every state that will successfully manage through the coming years while maintaining solid credit cushions.

Please feel free to contact us at research@gurtin.com for additional information.

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[16] http://www.governing.com/week-in-finance/gov-finance-roundup-harvey-illinois-bankruptcy.html and http://www.governing.com/topics/finance/gov-pension-envy-lessons-from-well-managed-plans.html

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