Illinois' missed pension payment tests legal boundaries but not the market
By Gunjan Banerji
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The **Illinois** Teacher's Retirement System (TRS) will not take legal action over the state's decision to delay a USD 560m payment due in November, a spokesperson for the TRS fund said.

The Illinois comptroller announced that the state would still commit to making the payment into the system of five pension funds on a later date, rather than eliminating it completely.

The five funds have an USD 111bn unfunded pension liability after taking pension holidays in FY06 and FY07 and issuing a USD 10bn pension obligation bond. The pension systems include TRS, the General Assembly Retirement System, State Employees' Retirement System, State Universities Retirement System, and Judge's Retirement System

Spokespersons for four of the five pension funds confirmed to *Debtwire Municipals* that they would not seek legal action against the state. The fifth, the State Universities Retirement System, did not return requests for comment.

Missed payments and missed opportunities

Despite the passive approach, pension system trustees have some incentive to act. Missing out on scheduled pension payments puts the retirement systems at risk of losing incremental investment returns, said John Fitzgerald of Tabet DiVito & Rothstein.

"It's not ideal, because if we did receive that money it could be invested in the various financial markets, and we could accrue returns on that money," said Jeff Houch, assistant to the executive director of the State Employees' Retirement System, Judge's Retirement System, and General Assembly Retirement System.

The 39% funded system will not receive interest payments on the delayed November contribution to compensate for missed returns. It is not allowed to receive interest under state law, the TRS fund spokesperson said.

This is not the first time the state delayed payment. Illinois lawmakers opted for pension holidays in FY06 and FY07 after issuing a USD 10bn pension obligation bond in FY03. Missing the payment has unclear legal ramifications, legal experts and market participants said. However, it could be a credit positive in the short-term for bondholders, but a definite credit negative in the long-term, said a municipal bond trader.

Déjà vu and the market shrugs

Moody's downgraded the state to Baa1 from A3 with a negative outlook today. Fitch downgraded Illinois' USD 27bn in bond debt to BBB+/stable on Monday, citing the state's ballooning pension liabilities. Standard & Poor's rates it A-/CreditWatch Negative.

Surprisingly, spreads have tightened slightly since the Fitch downgrade, said a municipal bond trader. In the short-term, postponing the pension payment could be viewed as a credit-positive—it indicates that the state is freeing up cash for other things such as debt service or even operations. Money is fungible, the trader said.

However, in the long-run, the decision is surely a credit-negative, the trader said. It's evident of Illinois management's disarray and piles on evidence that the state's hurdles are getting higher.

Illinois GO bonds maturing in ten years were trading 200 bps above the AAA MMD scale and have tightened to around 192bps above the scale, the trader said. This is due to investors' expectations of Illinois downgrades alongside wider market dynamics such as decreased supply.

"It's news that falls in line with what we've seen over decades, which is first making promises that aren't well thought-out from an actuarial perspective and, secondly, those promises not being honored on a timely basis," Fitzgerald said.

How bad is too bad

Previous Illinois comptrollers have not always paid in 12 monthly installments, sometimes using a quarterly schedule instead, according to a spokesperson for Illinois Comptroller Leslie Munger. The spokesperson said that only fiscal year payments are statutory, which implies that Illinois has until the FY16 close on 30 June 2016 before a cause of action would accrue.

"It's a fiscal year appropriation and how it's paid into the system or when it's paid into the system may be a matter of cash flow," said another Chicago-based pension attorney.

Even if the pension funds had a ripe claim, barriers erected by the Illinois Supreme Court make it difficult to compel pension payments that may compete with general obligation debt service, Fitzgerald said. A trio of cases between 1974 and 1998 established a precedent that only if a pension system is on the "brink of insolvency" can the courts order such payments.

But the standing test is a fuzzy one that has never been fully articulated. No one knows precisely how distressed a system must be before the Illinois justices would consider interfering with state spending decisions, according to Fitzgerald and the second pension attorney.

"That's really uncharted territory," Fitzgerald said. "It's territory that the Illinois Supreme Court has been reluctant to enter in the past, but of course things have changed a lot since the last time."

Muddying the waters

While the state argued that missing the USD 560m payment is legal, backing up its argument with past precedence, it veers into legal uncertainty while exacerbating its long-term problems. Violating a state statute may be the least of the Land of Lincoln's worries as it struggles to meet all of its obligations with considerably less revenue, said John Schomberg of Clark Hill.

"It's an open question on legality," Schomberg said.

Statutorily, the state is supposed to make a payment on the 15th of each month, according to the pension code. The state is choosing not to because of other competing budgetary items. The comptroller's spokesperson stated that not making the payment is simply a cash-flow issue. Every month the state has had to make choices regarding which bills it does or does not pay.

The further the state wades into the fiscal year without a budgetary solution, the less money there is to pay old bills, Schomberg said.