Chicago winks at bondholders while dissing pension funds

By Gunjan Banerji
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Chicago reassures bondholders that they are first in line to get paid in a police and fire pension reform bill (SB777) passed this spring. But the effort to gain investor confidence may prove futile in the long run, said two Chicago-based attorneys.

Illinois lawmakers passed SB777 while a nationwide conversation on the conflict between pensioners and bondholders unfolded. Now, stakeholders are watching to see if the provision makes its way into another reform bill for the city's largest pension fund, the Municipal Employees' Annuity and Benefit Fund (MEABF), and the smallest, Laborers' Annuity and Benefit Fund (LABF), both of which are dangerously close to insolvency. The two have a cumulative USD 21bn net pension liability.

Reform for the Policemen's Annuity and Benefit Fund (PABF) and Firemen's Annuity and Benefit Fund (FABF) phases in actuarially based payments for the funds. It also states that if Chicago fails to make good on the statute, the fund can "bring a mandamus action in the Circuit Court of Cook County to compel the city to make the required payment."

But there's an exception: the pension payments are second in line to principal and interest payments on bonded debt, according to SB777, which states:

"Any payments required to be made by the city pursuant to this Section are expressly subordinated to the payment of the principal, interest, premium, if any, and other payments on or related to any bonded debt obligation of the city…"

Some say that the provision was driven by institutional investors. Others claim that it was a move by the city to attain the lowest possible borrowing costs for the city.

"It demonstrates to the investors the intent of the issuer—to in fact protect [bondholder] investment rights," said Phil Fischer, a municipal research strategist at Bank of America. "Certainly as bondholders we appreciate it."

"Police powers" argument persists

"Now you have two different entities—pension funds and bondholders—that have the right to go to court," said John Schomberg, senior counsel at Clark Hill. "The language anticipates what happens if you have dueling court orders."

The provision is "built in as an escape hatch," signaling to the bond community that it's first in line to get paid, said a Chicago-based pension attorney. However, the added assurance may not stack up against Illinois' pension protection clause, which the state high court deemed paramount, Schomberg said.

The provision is a remnant of the ongoing police powers argument that the city has made in front of the Illinois Supreme Court, stating that there are emergency exceptions granting the city breathing room from a commitment to fund its retirement systems, the pension attorney said. This argument has failed in Illinois courts.

Additionally, it's unclear how any state statute would hold up under federal bankruptcy law, Schomberg said. A lack of formal Chapter 9 provision in Illinois doesn't mean an investor doesn't need to anticipate what might happen in bankruptcy court, said a buyside analyst.

The few municipal bankruptcies "have surprised us with the degree to which they give the pensions deference with regard to recoveries," Fischer said.

Pensions protest

"I have not seen that degree of 'wiggle-room' in an employer's funding obligation in legislation in the private sector (ERISA) or in government pension legislation with which I am familiar," said James McElligot, partner at McGuire Woods.

Despite the unusual nature of the provision, it isn't the only state statute that attempts to prioritize bondholders. A municipal bankruptcy bill providing a "statutory lien" to bondholders is outstanding in Illinois as well.

Some pension stakeholders fought the provision, according to a May 2016 letter from Tim McPhillips, FABF Active Trustee, seen by *Debtwire Municipals*, in which the stakeholder implores members to join him in rejecting it. McPhillips argues that SB 777 "jeopardizes" the pension fund, calling it a "direct assault" on the retirement systems because it lowered short-term payments and stretched out a path to reaching 90% funded.

The two funds have a combined USD 12.7bn net pension liability---PABF is 25% funded, and FABF is 22% funded, according to the city's FY16 annual financial analysis.

"The court can order the city to make [pension payments], but the courts are also going to be ordering the city to make good on the interest payments on the billions of dollars in general obligation debt on the city's books. What happens if the city cannot make both?" continues McPhillips in the letter, which repeatedly alludes to what would happen if Chicago's retirement system went to a "pay-as-you-go" status.

Chicago has USD 8.4bn in outstanding general obligation debt; its debt service has doubled over the past six years, as reported.

Creeping bondholder rights

Now that that the city has checked off a new plan for PABF and FABF, it is tackling MEABF and LABF. **Chicago Park District**'s pension reform, signed into law through Public Act 098-0622, has a similar provision. The reform has been challenged in state courts.

Chicago has not yet proposed formal legislation for MEABF or LABF, although it has committed to shoring the funds up with a utility tax and 911 surcharge, respectively. Now, some are concerned that similar language will creep up in Chicago's MEABF and LABF bills, said a source close to MEABF.

"How do you publicly support a bill when it says that your retirees will eat after the bondholders?" the source close said.

“This is at the crux of all economic questions; how to allocate limited resources,” writes McPhillips. His letter had asked members to call Governor Bruce Rauner (R) and demand that he veto SB777, which he ended up doing. But the Illinois House and Senate overrode his rejection.

The governor’s office referred comments on the matter to the City of Chicago, which did not respond to a request for comment. LABF declined to comment. PABF, FABF, and MEABF did not respond to requests for comment.

A USD 90.2m tranche of Series 2015C bonds issued by the City of Chicago last traded on 26 August at 103.7 yielding 4.5%, according to *Electronic Municipal Market Access*. Moody’s rates the city Ba1/negative while Fitch Ratings pegs it at BBB-/negative. S&P Global Ratings assigns a BBB+/negative rating to it; Kroll Bond Rating Agency assigns it a BBB+/negative rating.