Pennsylvania: A Case Study of How C.W. Henderson & Associates Evaluates Pension/Credit Risk

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C.W. HENDERSON
& ASSOCIATES, INC.
INVESTMENT COUNSELORS SPECIALIZING IN TAX-EXEMPT MUNICIPAL SECURITIES

As a defensively-styled investment manager, C.W. Henderson and Associates invests in high quality credits with strong liquidity characteristics. When researching state and local GO credits, we analyze numerous credit components that assist us in forming our investment recommendation. Pension funding is one of the most important credit components that our analysts monitor. This paper uses the example of Pennsylvania to illustrate how poor pension funding practices, combined with other credit factors, can help cause credit deterioration and spread widening. We also discuss the effects of an eroding state credit on local school districts.

Funded Ratio Declines and Causes

Pennsylvania maintains two state-run pension plans: The Employee Retirement System (ERS) and the School Employee Retirement System (SERS). In 2007, the plans boasted strong funded ratios of 97% and 86%, respectively. As of the 2016 actuarial valuation, those ratios stood at 58% and 50%. There were several factors that contributed to these substantial declines. First, plan participants received a generous benefit increase in 2001 due to both plans being overfunded. Over time, these enhancements helped lead to significant increases in ERS and SERS unfunded liabilities. Second, both plans' investment performance lagged their assumed returns. Over the past 10 years, the ERS plan returned an average of 4.3% while the SERS plan returned 5%, further pressuring funded ratios. Both plans assume annual returns of just over 7%. Lastly, and perhaps the most problematic, was a history of consistently underfunding the plans' actuarially-recommended contribution levels (ARC). In 2007, $900 million in actual contributions represented only 40% of the $2.3 billion combined ARC. By 2015, the ARC had more than doubled to $5.2 billion while actual contributions were only $4 billion.[1]

Budgetary Effects on the Commonwealth and Its School Districts

As funded ratios have plummeted, the ARCs have escalated considerably, rising from $2.3 billion in 2007 to $5.2 billion in 2015. Despite a history of underfunding their contributions, the state will fully fund these payments beginning in fiscal year 2017. Increasing pension costs, combined with a slow economic recovery, minimal revenue and population growth, political gridlock, and a nearly depleted reserve fund, have left the state in a precarious financial position. The chart below illustrates Pennsylvania's credit rating deterioration and spread widening from September 2011 to the present.[2]

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Pennsylvania GO	Sept 2011	Sept 2014	Sept 2017
Moody's Underlying Rating	Aa1	Aa3	Aa3
S&P Underlying Rating	AA	AA-	A+
Spread over the 10-year AAA-rated Municipal Scale	+18	+30	+52

[1] All statistical information sourced from the SERS & ERS 2016 Comprehensive Annual Financial Reports

[2] Credit spread information provided by J.P. Morgan

Rising pension costs have also helped pressure the finances of local school districts, which also contribute to the SERS pension plan. The Commonwealth ranks 46th in the nation when it comes to the state's share of education funding3, making local school districts heavily reliant on local funding. Property values have remained relatively flat over the past five years, leading to only modest local revenue gains. Minimal state aid and property value growth, combined with significant increases in pension funding requirements, have stressed many local school districts' finances. These factors, combined with flat-to-declining enrollment trends across most districts, have led to reserve draws and overall credit deterioration.

Conclusion

The C.W. Henderson research team performs a rigorous analysis of all our current and prospective holdings and evaluates numerous credit components before presenting a formal investment recommendation. Following a thorough analysis in mid-to-late 2011, C.W. Henderson & Associates opted to work out of the majority of our Pennsylvania GO and local school district holdings. Our recommendation pre-empted any rating agency downgrades or spread widening. As always, our research analysts are available to discuss Pennsylvania pension funding or any other credit issues.

[3] http://www.elc-pa.org/2017/03/07/education-law-center-releases-new-pa-school-funding-report-highlighting-racial-and-class-inequities/