ECONOMY

Lessons learned from the Motor City

THINK STRATEGICALLY:

Government Employee Retirement Cuts are Coming

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Retirement Under Title III Plan of Adjustment

The various retirement plans of the Government of Puerto Rico must be the focus of Title III bankruptcy proceedings under the Puerto Rico Oversight, Management and Economic Stability Act (Promesa). These retirement plans—particularly the central government's, which no longer exists and is honored on a pay-as-you-go plan, as well as pension systems covering teachers, the judiciary and public corporations—required a significant restructuring even before the commonwealth sought bankruptcy protection under Promesa in 2017.

Puerto Rico's various pension plans have an actuarial deficit that exceeds $49 billion. Most politicians have called the recently announced Title III plan of adjustment unacceptable because the retirement benefits will suffer reductions. To provide some perspective, we will analyze Detroit's bankruptcy and how it dealt with retiree benefits.

We begin by commenting that something rarely discussed is the reality that, since its creation in 1951, the Puerto Rico Government Employees Retirement System began operations with an actuarial deficit. This deficit was caused by Gov. Luis Muñoz Marín's insistence that all government employees, retired or not, receive benefits under the retirement system. To address the deficit created by such action, the government implemented a plan to pay down the actuarial deficit in 30 years, or by 1981, but it did not occur.

Over the years, far from addressing the deficit and problems, numerous special laws were enacted, establishing minimum benefits, death benefits, cost-of-living adjustments, additional death or disability benefits, contributions to medical plans, summer and Christmas bonuses, medicine bonds, the granting of personal loans to beneficiaries, and the infamous "Cadillac Pensions," all totaling billions of dollars.

These benefits accumulated while many years past and politicians did little to address this time bomb. In 1999, the actuarial deficit was around $6.4 billion; in 2009, the deficit reached $17 billion, and by 2014 the unfunded pension liabilities had reached $49 billion.

We find it tragic that after working 30 years for the government, having one's retirement benefits cut is probably one of the worst experiences anyone could face. We must be realistic and take a look at the Detroit experience as it serves as a mirror to what Puerto Rico retirees may ultimately face.

Why the Detroit Pension Experience Matters

Detroit filed for chapter 9 bankruptcy protection on July 18, 2013. At the time, it had been the largest municipal bankruptcy filing in U.S. history, until Puerto Rico's bankruptcy came along. The Motor City's debt was estimated at $18 billion to $20 billion. After nearly a year and a half of negotiations with bond insurers, labor unions, retirees and other creditors, a federal bankruptcy judge approved Detroit's plan of adjustment on Nov. 7, 2014. It allowed the city to exit municipal bankruptcy proceedings. Unfunded pension obligations and retiree health care costs amounted to $7.4 billion, or 41.1 percent of Detroit's $18 billion in debt. To address that cost in the future, it cut pension and health care benefits for retirees and reduced pension benefits for current workers upon retirement.

Changes to Retirement Benefits in Detroit

Pension benefits cuts: cost-of-living adjustments eliminated and base benefits cut an average of 4.5 percent for those in the General Retirement System.

A "hard freeze" of the existing pension plans and creation of two benefit plans: the plan of adjustment ended accrual of new benefits under legacy plans and created two retirement plans for current and new workers.

Health care coverage for retirees reduced and eliminated for new workers: A settlement between the city and retirees resulted in these benefits being funded and administered through two new trusts established by voluntary employee beneficiary associations (VEBA) for the two legacy retirement plans.

A near-term transition financing plan to provide budget relief: the Plan of Adjustment included agreements between the city and entities that called for contributions over 10 years from sources outside the city budget into the frozen plans.

Addition of significant cost-sharing features in the new pension plans: the new retirement plans kept a defined-benefit structure. However, they included robust cost-sharing features that require higher employee contributions or additional benefit reductions if plan assumptions are not met.

New investment committees established for additional oversight: State law established powerful investment committees to provide fiscal oversight over the newly created pension plans and the frozen legacy plans.

Detroit's adjustment plan was approved Nov. 7, 2014, setting up the city to emerge from bankruptcy in December 2014. Creditors and insurers absorbed losses of approximately $7 billion, with creditors receiving between 14 cents and 75 cents on the dollar.

As Puerto Rico is set to finalize its Plan Support Agreement with general-obligation and Public Buildings Authority bondholders, debt has been reduced from $18.8 billion to $7.4 billion, a 61 percent reduction. It also reduces debt service payments to $1.15 billion a year.

The Financial Oversight and Management Board (FOMB) proposed the following to address the situation of the Government retirement beneficiaries:

Creation of a pension trust to make sure retiree payments are protected and funded.

Enabled restoration of full pensions subject to outperformance.

System 2000 principal and interest restoration and transfer to individual segregated.

In their analysis it provided the following scenarios:

Plan of Adjustment Impact on Retirees		
Threshold	$1,200	$1,500
Number of retirees not impacted by cut	97,215	118,511
Percent of retirees not impacted	59%	72%
Average percent cut	3.3%	2.3%

While this information provided by the FOMB is not detailed enough to determine the full impact on government employees' pensions, it becomes clear that cuts are coming for some retirees.

Similar to the Detroit bankruptcy, a complete overhaul of Puerto Rico's retirement systems, with reductions in benefits and healthcare will occur to finalize Puerto Rico's plan of adjustment.

Week in Markets: Stock Rotation Versus Interest Rate; Employment Rises, Wall Street Gains

The U.S. stock markets closed the week with gains following the week's massive sell-off.

There are two emerging views from investors that are causing the stock and bond markets' increased volatility.

Some believe that rising interest rates and increasing stock prices cannot coexist and others view our belief that the stock market is in the middle of a stock rotation, from companies that benefited most from the pandemic to those shunned but are now attractive buying opportunities.

Allow me to address both views. While rates have risen, they are not high and are back to where they were exactly one year ago. Also, the average rate in the past 20 years for a U.S. 10-year treasury note is 3.1 percent, and last week, it closed at 1.56 percent, with ample room to grow. The other stock rotation view may be more accurate as investors are trading out of tech stocks that benefited during the pandemic. Note the Nasdaq index pulled back last week 1.39 percent and is at 0.25 percent for the year.

The change of fortune is partly due to the February jobs report, which showed nonfarm payrolls rising to 379,000, up from 166,000 in January, or a 128.3 percent growth that may reflect a quicker recovery of the U.S. economy. While Friday's close was positive, we reaffirm that periods of volatility will remain over the coming weeks as market balance is reached.

Weekly Market Close Comparison	3/5/21	2/26/21	Return	YTD
Dow Jones Industrial Average	31,486.30	30,932.37	1.79%	2.91%
Standard & Poor's 500	3,841.94	3,811.15	0.81%	2.29%
Nasdaq	12,920.15	13,102.34	-1.39%	0.25%
Birling Puerto Rico Stock Index	2,350.74	2,269.48	3.58%	14.95%
U.S. Treasury 10-Year Note	1.56%	1.44%	8.33%	0.55%
U.S. Treasury 2-Year Note	0.14%	0.14%	0.00%	0.60%

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