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Plight of Public Pensions Not So Ominous, as Funding of Most Plans Expected to Improve

BY KEITH BRAINARD

Bob Williams painted an ominous picture of the current state and future of public pension plans in his BNA Insights article titled ''It's Overwhelming: Fundamental Flaws Doom Governmental Defined Benefit Plans'' (225 PBD, 11/26/12;39 BPR 2273, 11/27/12), in which he relies on a litany of hand-wringing and doomsday predictions about the current and future condition of public pension plans.

Fortunately, the actual condition of the pension plans covering the vast majority of employees of state and local government is far better. Williams's pessimism relies on a careful selection of sources and disregards the views of credible experts. He also errs in treating public pensions as a single, uniform entity and by overlooking the effects of the substantive pension reforms approved in recent years by nearly every state.

Williams begins by contending that states and local governments failed to fund public pension promises. In fact, most states and cities in recent years have paid all or most of their required pension contributions; some have not. As with most public pension issues, the answer is not black and white, but rather, varies widely from state to state and plan to plan.

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A Few in Trouble, Most Not

In her book, *State and Local Pensions, What Now?*, Alicia Munnell, the director of the Center for Retirement Research at Boston College, states:

> [A] relatively small group of states—Illinois, Kentucky, Louisiana, New Jersey, and Pennsylvania– could be considered bad actors in terms of pension funding. . . . These states have led many observers to conclude that public pension plans generally have been mismanaged. But an equally large number of states—Delaware, Florida, Georgia, Tennessee, and New York—have done a good job in terms of providing reasonable benefits, paying the ARC [annual required contribution], and funding. They, like all entities, have been battered by the financial collapse and ensuing recession, but their funding status should improve as the economy recovers.[1]

According to the Public Fund Survey, the average ARC received by public pension plans since FY 2001 has been nearly 90 percent. This includes many plans that have consistently received 100 percent or more of their ARC, and some that have consistently received far less.

An overarching image of public pensions depicted by Williams is that all public pension plans are unsustainable and in poor condition. In fact, a wide range exists in public pension funding levels and conditions, even within some states. In its 10th Annual Public Pension Funding Review, Loop Capital states:

> Despite the continued clamor, our view remains fundamentally the same as last year: The public pension plan problem is state specific, and not systemic in nature; the pace of improvement across the states is uneven, with some states making little or no progress while others advance; each state has its own unique path to recovery.[2]

The treatment of public pensions as a single, uniform entity is similarly addressed by Nuveen Asset Management:

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[1] Alicia H. Munnell, *State and Local Pensions: What Now?* (2012)

[2] Chris Mier and Ann Kibler, *Tenth Annual Public Pension Funding Review* Loop Capital Markets (Sept. 2012), http://www.wikipension.com/images/2/20/Loop12.pdf.

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> Though headlines and various reports may discuss municipal issuers and their pension obligations as a uniform problem, the reality is that the municipal market remains highly individualized and doesn't lend itself to sweeping generalizations.[3]

Risk-Free Interest Rate Versus Reality

Williams also cites estimations of liabilities that are calculated through the use of a so-called risk-free interest rate. When calculating pension liabilities, the lower the interest rate, the higher the liabilities. Because the Federal Reserve Board's current monetary policy is artificially keeping interest-rate yields near record lows, this method for assessing liabilities produces a record and artificially high calculation.

The $5 trillion estimate of aggregate liabilities cited by Williams is based on an interest rate of 3.36 percent. This rate is lower—substantially—than not only the rate used by public pension plans, but it is also far lower than the rate used even by corporate pension plans. Moreover, this calculation has little practical value: It is not helpful for determining a pension plan's required contributions or how a pension fund should invest its assets. In reality, this approach reveals more about the nation's bond market than anything else.

Long-Term Investment Returns

Williams's charge of ''lax accounting practices'' used by public pensions presumably refers to the manner in which they calculate their liabilities. Rather than using current interest rates, public pensions calculate their liabilities using their expected long-term investment return, typically 7.5 percent to 8 percent. This method is intended to promote stability and predictability in the cost of the plan and to ensure each generation of taxpayers pays for the cost of public services it receives. During the past 10-, 20-, and 25-year periods, public pension funds have met or exceeded their expected long-term investment returns.[4]

The use of the long-term expected investment return has also been endorsed by the Governmental Accounting Standards Board (GASB). After several years of consideration and debate, GASB recently issued new standards for how public pensions determine and report their liabilities (122 PBD, 6/26/12; 39 BPR 1270, 7/3/12). GASB heard from a wide variety of industry observers and participants and considered all perspectives. Ultimately, GASB rejected the economists' preferred method for valuing pension liabilities, instead preserving the use of the plan's long-term expected investment return as long as the plan is projected to have assets.

Charles Millard, former executive director of the Pension Benefit Guaranty Corporation, said recently ''the discount rate should not be based on the interest rates we see right now. It should be based on what we think those liabilities are likely to cost over decades. An average, or a smoothed, interest rate makes much more sense.''[5]

The national benefits consulting firm Milliman, in its 2012 Public Pension Funding Study, said it believes a discount rate of 7.65 percent is appropriate for public pensions, stating:

> [T]here are only a small number of plans whose interest rate assumptions are causing a sizeable underreporting of liability relative to what would be calculated based on current forecasts of future investment returns; in fact, there are a surprising number of plans whose interest rate assumptions and accrued liability reporting are conservative in light of current forecasts.[6]

Williams also minimizes the value of the many public pension reforms approved by nearly every state in recent years, contending that states and cities have ''done very little, if anything, to address the unfunded liability.'' That charge would be news to policymakers and plan participants in a growing number of states, including Colorado, Florida, Maine, Minnesota, New Jersey, Oklahoma, Rhode Island, and South Dakota, where pension reforms have reduced unfunded liabilities by billions of dollars and reduced employers' future pension costs.

Public Pension Reforms

In its 10th Annual Public Pension Funding Review, Loop Capital recognized the value of reforms around the country, saying: ''There has been a record setting number of fiscally responsible pension reform measures enacted this year that focus on addressing the structural deficiencies in most public pension plan systems. . . . The solution to the pension crisis depends on the magnitude of the problem.''[7]

Standard & Poor's, in a June 2012 report, also recognized the value of the reforms Williams scoffs at:

> Pension systems are undergoing the most significant level of reform in decades, which we view as a credit positive. . . . Most states have sufficient assets in their pension trusts to fund benefits payments over the near to medium term and in many cases, long term. Contributions to fund the state share of pension benefits typically represent a relatively small portion of state budgets and we don't expect them to threaten debt-paying abilities in the near term.[8]

One type of reform that has been implemented in many states has been the imposition of higher pension contribution rates for employees. According to the National Conference of State Legislatures and the National Association of State Retirement Administrators, required contribution rates have been increased in re-

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[3] Shawn P. O'Leary, *Municipal Pension Funding: A Tale of Four Cities* Nuveen Asset Management (Oct. 2012), http://www.nuveen.com/Home/Documents/Viewer.aspx?fileId=57279.

[4] National Association of State Retirement Administrators Issue Brief: Public Pension Plan Investment Return Assumptions (updated Jan. 2013), http://www.nasra.org/resources/issuebrief120626.pdf.

[5] Charles Millard, *Pension Reform Could Stem DB Plan Closures* FundFire (Jan. 7, 2013).

[6] Rebecca A. Sielman, *2012 Public Pension Funding Study* Milliman (Oct. 2012), http://www.milliman.com/expertise/employee-benefits/products-tools/public-pension-funding-study/pdfs/2012-public-pension-funding-study.pdf.

[7] Chris Mier & Ann Kibler, *Tenth Annual Public Pension Funding Review* Loop Capital Markets (Sept. 2012), http://www.wikipension.com/images/2/20/Loop12.pdf.

[8] John Sugden, Robin Prunty, and Gabriel Petek, *The Decline In U.S. States' Pension Funding Decelerates, but Reform and Reporting Issues Loom Large*, Standard & Poor's (June 21, 2012), http://wikipension.com/images/d/d9/2012_Pension_Report.pdf.

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cent years for employees in 28 states. In many cases, required contributions are applied not just to new hires but also to existing plan participants.

Standard & Poor's has acknowledged that states and cities have a long track record of making changes necessary to maintain the sustainability of their pension plans. Investment markets continue to recover, and public pension funding levels will improve as a combination of lower benefits, higher employee contributions, and rising investment markets reduce unfunded pension liabilities and pension costs.

Taking Steps in the Right Direction

Unquestionably, there are examples of serious funding problems among public pensions. In particular, states and cities that have failed to make required contributions, and some that have increased benefits without ensuring a means to pay for those benefits, are in trouble. In most cases in which pension shortfalls are serious, plan sponsors have taken action or are working to do so.

The pessimism Williams displays is unjustified, as is the implication that every public pension plan is unsustainable. State and local governments should base policy decisions on facts, not anecdotes. Rather than pronouncing that the sky is falling, a more productive and informed discussion of public pensions would acknowledge their true nature: A few are in trouble; most are not. Attention needs to be focused not on the entire public pension community, but on those that who have approved benefits without knowing how they would be funded, and those that have failed to fund their required contributions.

In its report, ''States' Pensions: A Manageable Longer Term Challenge,'' Barclays Capital Municipal Credit Research says:

> ''Though the size of the pension shortfall is large, pension liabilities are longer term, and the plans have sufficient assets to pay annual benefits for at least the next 17 years, on average, before including future contributions and investment earnings. Moreover, state and local governments have begun to take action to reduce the pension liabilities and/or grow assets, including increasing employee contributions and reducing benefits for future employees. Though most of these actions affect only future employees and do little to address the unfunded liabilities currently reported by the states, they represent a step in the right direction.''[9]

Wells Fargo Municipal Securities Research said in August 2012: ''There is a good deal of confusion about pensions and other retiree benefits in the public sector. The unfunded obligations that are grabbing headlines come due over a long-term horizon of 30 years or more. Long-term solvency *is* achievable and many state and local governments have initiated meaningful change.''[10]

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[9] Austin Applegate, Jormen Vallecillo, and Katharine Cheng, *States' Pensions: A Manageable Longer-Term Challenge* Barclays Capital (May 18, 2011), http://wikipension.com/images/9/98/Barclays1105.pdf.

[10] Natalie Cohen and Roy Eappen, *Pension Tensions: A Primer* Wells Fargo Securities (Aug. 22, 2012), http://www.wikipension.com/images/e/e0/WellsFargopensiontension1208.pdf.