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Poisoned Pensions

By Chris Tobe *Tue, Jun 26, 2012*

Poor investments and rich benefits play a role in state pension underfunding, but they are insignificant compared to the lack of full contributions, writes Chris Tobe. SEC and the ratings agencies have neglected deliberate underfunding of the plans, he says.

The current political rhetoric on public pensions that blames their problems on gold-plated benefits and unrealistic investment assumptions misses the point. The dirty little secret in at least 14 states is that politicians have badly misled the public: both political parties have conspired to secretly borrow hundreds of billions of dollars from their state employee pensions.

This paper asks why the Securities and Exchange Commission and ratings agencies like Standard & Poor's and Moody's have allowed this to happen.

Public pensions are exempt from ERISA, so they receive no direct federal regulation, and state regulation of public pensions has proven itself largely ineffective. Virtually the only watchdogs are the regulators and independent reviewers who are supposed to provide investors with an honest view of state finances when states borrow money through the municipal bond market. Supervision of pensions is weak.

The deliberate underfunding of pensions has been a backdoor method of borrowing from the plans. Public pension actuaries calculate exactly much funding the plans need each year to run in a balanced fashion. This Actuarially Required Contribution (ARC) is typically mandated by state law, and most state constitutions require a balanced budget. But the 14 states named below have only paid a fraction of their ARC for many years in a row, thus taking on an undisclosed, illegal debt that is senior to municipal bonds. Legislators and governors of all political persuasions have implemented this maneuver.

The vast majority of the lowest funded plans have made subpar ARC payments. These states—which include Illinois, Kentucky, Oklahoma, Rhode Island, Connecticut, Colorado, Alaska, Minnesota, New Jersey, Kansas, New Mexico, Pennsylvania, Maryland, and Missouri, according to the Center for Retirement Studies at Boston College—have made partial payments over the past seven years, breaking the balanced budget clauses of their own constitutions and defying the rules of pension mathematics. They have paid only half of their "mortgage payment" for 10 years. Their documented pattern of underpayment, which is the main driver of funding ratios in the 20%, 30% and 40% deciles, proves that these are self-inflicted wounds.

This lack of full ARC funding is the most immediate reason for the low funding ratios of Illinois SERS (23%), Oklahoma Teachers (27%), Rhode Island Employees (29%), Connecticut Teachers (32%), Colorado PERS (34%), Alaska Teachers (37%), Minnesota PERF (37%), New Jersey Teachers (38%), Kansas (38%), New Mexico Teachers (38%), Pennsylvania Schools (43%), Maryland PERS (43%) and Missouri Teachers (45%).

In Kentucky, we have two funds with nearly identical investments and similar benefits. But CERS, which has paid 100% of its ARC, is nearly 60% funded, while KERS, which has paid less than 50% of its ARC, is now less than 30% funded. Even in a year (FY11) with investment returns of nearly 19%, the assets in KERS grew by only 1% due to the negative cash flows from underfunding.

Investment returns for the fiscal year ending June 30 will be flat at best and funding ratios will fall even farther. Once a plan's funding ratio reaches 40% or less, it can enter a death spiral unless the state stabilizes it with 100% of the ARC. There is little sign of this will happen in these 14 states. Last week, Illinois failed to get to a 100% ARC. The other states are likely heading toward a similar impasse.

Pensions are designed to withstand periods of investment underperformance if they are funded correctly. Their funding ratios dip, but eventually come back. This is not true of an underfunded plan. Double-digit returns in a fund that's 30% funded are the equivalent of three percent returns in a fully funded plan. This diluted return often cannot keep up with the outflow of retiree checks, which further compounds the liability. A shift to riskier assets does little in such situations except to create liquidity issues. The question of whether to assume an expected investment return of 8% or 4% hardly matters.

When criticizing state plans, the media focuses on retirement age and assumed rates of return. These are long-term issues that are relevant to the solvent plans that pay the full ARC. But for these 14 states, the salient issues are solvency and liquidity. The only solution is for the state to pay the full ARC—this year and every year from now on.

I contend that ratings agencies—Standard & Poors, Moody's and Fitch Ratings—and the SEC have been enablers of this problem. They have allowed a partial payment culture to exist and have failed to punish states and localities for not meeting their ARC. If states had paid half their *municipal bond* coupons, the rating agencies would have downgraded them. But in the case of pensions they looked the other way. For the most part they have ignored pension liabilities until very recently, and now it may be too late for many states. The excuse of the ratings agencies is that states can always rely on their unlimited taxing powers to make up the ARC payments.

The ratings agencies have repeatedly let states off the hook with vague plans to pay, for instance, 50% of the ARC now and the rest later. But the widespread strength of anti-tax sentiment makes belief in such promises naïve at best. Attempts to achieve the full ARC have run into repeated roadblocks. One recent response has been to cut traditional subsidies to local governments and school districts and force them to pay the full ARC. But the pension debt shortfall cannot compete with the other funding pressures states face when there's no credible threat of punishment for shortchanging the plans. If legislators have to choose between raising taxes, firing teachers or policemen, and borrowing from the pension, they will choose the latter.

In nearly all near-bankrupt plans (like Kentucky's ERS), the ARC is not being met. Poor investments and rich benefits play a role in underfunding, but, especially in the short term, they are insignificant compared to the lack of contributions. Because states are "too big to fail," this has national implications. Pension underfunding could lead to state bankruptcies or federal bailouts. By looking the other way and not holding states accountable for underfunding the ARC, the SEC and the ratings agencies have helped create a downward spiral that will be politically difficult, if not impossible, to reverse.

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