Unfunded Pension Obligations and Their Impact on State and Local Governments

The topic of unfunded pension liabilities has garnered growing attention from a public confronting headlines warning of the staggering size of unfunded obligations, and lawmakers looking to pension funding amid ongoing budget stress. We believe that state and local pensions and the challenges they pose for the municipal asset class are highly individualized and should be viewed by investors on an issuer-by-issuer basis. MTAM looks past the headlines and conducts fundamental credit research on individual issuers. We analyze an issuer's pension funding status by reviewing its plan assumptions, annual pension contributions, and funded ratios as they relate to the actuarially based annual required contribution, or ARC, and the amount it represents in an issuer's overall budget. We also look at whether the issuer is making the full ARC payment and consider the size of the unfunded liability on a per-capita basis, as a percentage of an issuer's tax base, and as a percentage of personal income.

U.S. states are short $1.26 trillion they should have set aside to pay retired workers, according to the Pew Center on the States. The economic struggles of the past decade lit the fuse for the pension fund time bomb. In 2000, half of the 50 states had enough money set aside to cover future pension costs, according to Pew. By 2008, only four states -- Florida, New York, Washington and Wisconsin -- could make that claim. The other 46 are potentially on the road to insolvency. Supersized government worker pay, granting supersized pensions seems irresponsible in light of this looming fiscal catastrophe. Yet, in California alone, nearly 10,000 retirees will get pension checks totaling at least $100,000 this year.

Many states and local governments are acknowledging that they have promised pensions they cannot afford and are cutting once-sacrosanct benefits, to appease taxpayers and attack budget deficits. Illinois raised its retirement age to 67, the highest of any state, and capped public pensions at $106,800 a year. Arizona, New York, Missouri and Mississippi will make people work more years to earn pensions. Virginia is requiring employees to pay into the state pension fund for the first time. New Jersey will not give anyone pension credit unless they work at least 32 hours a week.

But there is a catch: Nearly all of the cuts so far apply only to workers not yet hired. Though heralded as breakthrough reforms by state officials, the cuts phase in so slowly they are unlikely to save the weakest funds and keep them from running out of money.

Lawmakers wanted to avoid legal battles or fights with unions, whose members can be influential voters. So they are allowing most public workers across the country to keep building up their pensions at the same rate as ever. The tens of thousands of workers now on Illinois's payrolls, for instance, will still get to retire at 60 — and some will as young as 55. One striking exception is Colorado, which has imposed cuts on its current workers, not just future hires, and even on people who have already retired. The retirees have sued to block the reduction. Colorado is basing its legal defense, in part, on a 1961 state supreme court ruling that said pension cuts for current workers were allowed if "actuarially necessary," and will argue that it applies to retirees as well.

Other states with shrinking funds and deep fiscal distress may be pushed in this direction and tempted to follow Colorado's example in the coming years. Though most state officials believe they are legally bound to shield current workers from pension cuts, a Colorado victory could embolden them to be more aggressive. Colorado pruned a 3.5 percent annual pension increase to 2 percent, concluding that was the fastest way to revive its pension fund, which was projected to run out of money by 2029. The cut may sound small, but it produces big results because it goes into effect immediately. State plans vary widely, but many have other costly features, like subsidized early-retirement benefits, which could likewise be trimmed for existing workers.

Joshua D. Rauh, an associate professor of finance at Northwestern University who studies public pension funds, predicts that at the current rate, Illinois's pension system could run out of money by 2018. He believes the funds of other troubled states — including New Jersey, Indiana and Connecticut — are also on track to run out of money in less than a decade, unless they make meaningful changes. If a state pension fund ran out of money, the state would be legally bound to make good on retirees' benefits. But paying public pensions straight out of general revenue would be ruinous. In Illinois's case, it would consume about half the state's cash every year, bringing other vital state services to a standstill. Any state caught in that trap would have little choice but to seek a federal bailout. Bigger pension contributions and higher taxes can go only so far.

U.S. states' deficits in their employee retirement systems widened by 26 percent in fiscal 2009 as governments were stung by investment losses and failed to pay enough into their pension funds. The deficits, or the difference between the retirement and health-care benefits states have promised their employees and the assets set aside to fund them, grew to $1.26 trillion by the end of the 2009 budget year from $1 trillion a year earlier.

The gaps are straining governments that have yet to fully recover from the recession and are stoking political fights in states such as New Jersey, Ohio, and Wisconsin over the workers' benefits. They have also drawn scrutiny in Congress, where Republicans have held hearings into the risks posed by underfunded pensions and backed legislation that would bar the federal government from bailing out any ailing funds.

The fiscal 2009 setback may continue to weigh on states that count on annual returns of about 8 percent and use accounting methods to spread their losses across years. In 2009, state retirement systems had 78 percent of what they needed to pay for promised pensions, down from 84 percent a year before. The unfunded liability in state-run pension plans rose to $660 billion in 2009 from $452 billion a year earlier, which rely on the funds' expected rates of return to calculate long-term liability. That deficit projection would grow to $1.8 trillion under corporate-style accounting methods, which use lower expected returns. The states are also facing the rising cost of employee health care benefits that, unlike pensions, are largely financed as the bills come due. Such expenses accounted for $604 billion of the retirement systems' deficits. Those health-care obligations may squeeze large states if medical costs keep rising as baby boomers retire over the next decade.

The biggest unfunded pension liabilities in 2009 were in Illinois, which had just 51 percent of what it needed to pay for promised benefits, and West Virginia, with 56 percent. New Hampshire was 58 percent funded, while New Jersey and Ohio both had just two-thirds of what they needed. On the other end of the spectrum, the pension plans in New York and Wisconsin were fully funded. Some states worsened their problems by not making full payments into their pension

funds each year. Pennsylvania paid only 31 percent of its required contribution in 2009 and New Jersey 36 percent. Both Wisconsin and New York made their full payments.

Legislation affecting labor was proposed nationwide this year, as states faced a collective budget gap of $103 billion. The disputes go well beyond Wisconsin, site of the best- known confrontation, where Governor Scott Walker won legislation to curb collective bargaining by most public workers. Unions staged protests and sit-ins while Democratic lawmakers left the state in an effort to prevent a vote.

It was a ground-breaking year for collective bargaining legislation, as every state had bills introduced, and significant pieces of legislation were passed in 15 states. It is likely that collective bargaining will continue to be a hot issue in the 2012 legislative sessions. The National Association of State Legislatures reported that 848 bills concerning collective bargaining were introduced in this year's legislative sessions. About 560 of the bills focused on government unions and workers, including state employees, teachers, firefighters, police and transit workers. Ultimately, 49 bills were enacted in 23 states, according to the Association.

The hardest-fought conflicts came in states with newly elected Republican governors such as Walker. In the aftermath of the Wisconsin legislation, six Republican state senators face union-backed recall elections on July 12, while three Democratic senators face such votes on July 19.

In Ohio, Republican Governor John Kasich won enactment of a law limiting collective bargaining for public employees. We Are Ohio, a group including Democrats and labor unions, delivered petitions for a referendum on the measure that would be held in November. The group said it submitted 1.3 million signatures to be verified. The secretary of state's office said 231,000 valid names are needed to place the issue on the November 8 ballot.

In Florida, Republican Governor Rick Scott had less legislative success. A measure he supported prohibiting state and local government from automatically deducting union dues from employee paychecks failed to pass before the end of the session on May 7. A number of Republican lawmakers sided with labor.

In New Jersey, lawmakers gave final approval to Republican Governor Chris Christie's plan to increase pension and health-care expenses for public workers to reduce a $53.9 billion deficit in the retirement system and save state and local governments more than $130 billion over the next 30 years. It sets worker contributions for medical coverage without union bargaining for four years.

Democratic governors in some states also extracted concessions from their union allies. In New York, Governor Andrew Cuomo had threatened to fire almost 10,000 workers unless they agreed to $450 million in concessions. In Connecticut, Democrat Governor Daniel Malloy proposed firing almost $5,000 state workers to eliminate a deficit after unions rejected a concession agreement aimed at cutting job cuts.

In states from Maine to Utah, measures to curb union power and benefits were among unfinished business as legislatures have adjourned for the summer. Labor leaders say conflicts will only escalate when lawmakers return because unions and their opponents will be working to mobilize supporters for next year's presidential, congressional, and state elections.

When MTAM analyzes the credit impact of an issuer's pension obligations, we look at how the funded ratio — the difference between plan assets and liabilities — is reached. Actuaries reach ratio estimates by considering investment return rates, retirement age, inflation, discount rates that assign a present value to futures payments, and annual salary increases. Even slight changes in those assumptions can dramatically change a funded ratio. Investment results are usually smoothed out over a period of time that varies depending on the issuer. While most issuers smooth out results over three to five years, the California Public Employee Retirement System smooths returns over a 15-year horizon. The longer the smoothing period, the greater the likelihood the reported asset value will materially depart from current asset value.

Some analysts and public policy groups have warned that funds are counting on overly aggressive investment return rates. MTAM's contention is that a more detailed review of how a plan's assets are invested is needed, or at least a review of a plan's historical performance, before deciding on whether an issuer's assumed rates are reasonable. We also pay close attention to the actuarially determined ARC and whether an issuer historically has met that payment. MTAM will avoid municipalities that routinely fail to meet the ARC. We also look at whether issuers are scaling back on ARC payments to inflate the health of their general fund.

There is a positive note to the current headlines of the plight of pension funding. When you look at fiscal stress in general, these periods of heightened awareness give elected officials the political leverage they need to effect change. Over the long term, we expect officials will move towards restructuring these plans in a sustainable way. That power from the public — resistant to paying higher taxes or seeing services cut amid ongoing budget challenges — is needed as elected officials face politically difficult decisions, such as whether to anger unions by demanding contribution increases or benefit cuts. MTAM holds a positive view that governments will improve the status of their pension funds over time and that ultimately debt service to bondholders will not be imperiled.