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Puerto Rico Illustrates Need For New Public Employee Pension Disclosures.

It's said that behind every strong man is a strong woman. In the world of public finance, however, we can say that behind every quasi-insolvent public entity – from Detroit, to Puerto Rico, to bankrupt California cities such as Stockton and San Bernardino, to the State of Illinois and the City of Chicago – stands a poorly-run public employee retirement plan. As Congress drafts an insolvency rescue plan for Puerto Rico, it has the opportunity to prevent future Puerto Ricos by increasing the transparency of public employee pension funding and to reduce incentives for state and local governments to underfund their plans and to take excessive risk with their pension investments.

State and local governments face financial distress for many reasons. But it is near-impossible to find a governmental entity nearing insolvency that has a well-run and well-funded retirement plan for public employees. For instance, California's public employee plans implemented a retroactive benefit increase in 1999, passed on the last day of the legislative session, that increased benefit payments by billions of dollars. The cities of Stockton and San Bernardino declared bankruptcy under pressure from rising pension costs. Illinois has for years used creative accounting to avoid making full pension contributions. Today, under pressure from pension costs, Illinois can barely afford to pay lottery winners. Chicago received a "holiday" from making pension contributions, but was unprepared to resume contributions when that respite ended. Chicago's schools now face the choice between making pension payments and providing materials for classrooms. Detroit's main public pension was essentially looted by its participants, with extra payments and diversions of funds to workers 401(k)-type plans. Puerto Rico's public employee plan paid Christmas and summer bonuses and loaned public employees money to take overseas vacations, with the pension paying half of the interest on those loans. Puerto Rico's pension funding level verges on zero, and about 20 percent of the retirement system's remaining "assets" consist of mortgage, personal and vacation loans made to the plan's participants.

Puerto Rico now faces insolvency. In other words, it simply cannot pay all its debts and Congress is trying to arrange some bankruptcy-type process by which losses can be allocated. Legally-speaking, in Puerto Rico as in other communities, holders of explicit governmental debt are held to be senior to participants in the pension systems. As the New York Times has reported, Puerto Rican law has eight levels in the order of repayment of various forms of government debt, only after which would pension obligations be satisfied.

But the Obama administration Treasury Department's proposal changes all that: under a draft plan, priority is given so that the rescue plan "not unduly impair the claims of any class of pensioners." Only after that, "if feasible," would bondholders be repaid. In other words, the usual, legal order of repayment has been upended. But that's not out of the ordinary: in Detroit, Stockton and San Bernardino, retirees took only minor losses – or no losses at all – while bondholders often received back only pennies on the dollars. That's important, since it's not just Wall Street hedge funds holding those municipal bonds. Especially with Puerto Rican bonds, many ordinary savers purchased municipal bonds to finance their own retirements. Those savers, who did nothing wrong, will see the legal terms on which they purchased those assets overturned and will suffer in retirement as a

result.

It may be too much for the political system to allow a large and organized group of citizens to suffer through no fault of their own, regardless of the legalities. But at a minimum, any reorganization plan for Puerto Rico that favors the pension plan over bondholders should include reforms to reduce the chance of a future insolvency. Those reforms should come in the form of improved financial disclosures for state and local government retirement plans.

When a state or local government wishes to issue bonds, it publishes a prospectus that includes information on the other debts of the government. Among those debts are liabilities to the government's public employee retirement plan. The pension liabilities published in those bond prospectuses are calculated in a way that is inconstant with financial theory and with how other pension plans are required to calculate their liabilities, and are done in a way that literally 98 percent of economists believed understated the true value of pension liabilities.

In other words, state and local governments are borrowing from the public while providing misleading measures that understate their true pension liabilities. And since, as Puerto Rico's example shows, pension benefits will in practice be paid before municipal bondholders, prospective bond purchasers are being misled regarding the possibility of non-payment. In any other context, this would be a clear-cut consumer protection case in which the public deserves honest and accurate information.

How does this take place? U.S. state and local pensions operate under accounting rules that are unique in the financial world. These rules, which are established by the Governmental Accounting Standards Board (GASB), allow public pensions to value - or "discount" - their future pension benefit liabilities using the assumed rate of return on the investments held by the pension plan. At first this might seem reasonable. But under scrutiny, there's a good reason why other pensions aren't allowed to do this.

The benefits offered by state and local pensions are guaranteed. They're advertised to participants as guaranteed, state laws and constitutions often deem them to be guaranteed and, when push comes to shove, retirement benefits are more likely to be paid than explicit government debt. Discounting a guaranteed benefit using the assumed return on a portfolio of risky assets tells you the "expected" cost of paying those benefits, assuming all goes as planned. But it doesn't tell you the cost of *guaranteeing* them. And the liability presented by pension benefits isn't to pay them if everything goes as planned. The liability - that is, the thing the state or local government is legally obliged to do - is to pay those benefits under practically *all* circumstances, come what may.

Economists and financial markets know how to express the true value of a guaranteed liability: by discounting the future benefit payments using an interest rate that's commensurate with the risk of the benefit. If, say, we believed that a pension's benefits are as guaranteed as U.S. Treasury bonds - meaning, those benefits will be paid under almost any foreseeable circumstances - then those liabilities should be discounted using the yield on Treasuries, currently about 2 percent. As Donald Kohn, then Vice-Chairman of the Federal Reserve Board, put it in 2008, "The only appropriate way to calculate the present value of a very-low-risk liability is to use a very-low-risk discount rate."

This is how pension accounting works pretty much anywhere except in the state and local pension world. A U.S. corporate pension plan, for instance, must discount its liabilities using the yield on corporate bonds, currently around 4.1 percent. In other words, pensions are considered to be liabilities on par with explicit corporate debt. That lower discount rate produces a higher present value of liabilities and thus requires the plan to set aside more money to fund its benefits. A corporate pension isn't required to invest its assets in corporate bonds; it can invest in risky assets

like stocks if it likes. But it must value its pension liabilities based on the liabilities own risk, not the risk of the assets used to fund those liabilities. The same goes with most overseas pensions, including pension plans for public employees in other countries. (See my [2015 AEI paper](#) for details on pension plans abroad.)

The result of this faulty GASB accounting is that a bond prospectus issued by almost any state and local government dramatically understates the true value of its pension liabilities. For instance, I pulled up a 2010 [prospectus](#) published by the State of Illinois which reported that the state's various retirement plans had total liabilities of \$126.4 billion and assets of \$64.0 billion. This implies an unfunded pension liability of about \$62.4 billion, against which - in a time of fiscal distress - Illinois's explicit bondholders would compete (and presumably lose).

What the prospectus doesn't disclose is that this liability was calculated using an assumed investment return of 8.5 percent, at a time when the yield on safe U.S. Treasury securities was 3.2 percent. Were Illinois pension liabilities calculated using a Treasury yield - which seems appropriate, since the Illinois Supreme Court has recently ruled that that accrued public pension benefits are guaranteed - total liabilities would have been listed at about \$332 billion and unfunded liabilities at around \$270 billion. Those figures would give bond purchasers a much more realistic picture of how far back they stand in line for repayment.

State and local pension accounting rules have a second perverse and destructive effect: they induce government pensions to take excessive investment risk. Here's the logic: under GASB rules, a public plan gets to discount its liabilities at the expected return on the plan's investments. Riskier investments have higher returns than safe investments. So shifting a plan's portfolio toward riskier investments allows it to assume a higher return, apply a higher discount rate to its liabilities, and reduce the contributions it needs to make to service those liabilities.

Corporate pensions and public employee pension in other countries apply a conservative, fixed discount rate to their liabilities, so they don't have the incentive to take excessive investment risk. A [2014 survey](#) by the OECD found that the typical large private pension fund in a developed country held about 52 percent of its assets in bonds, 32 percent in stocks, 15 percent in alternative investments like private equity, hedge funds and real estate, and 2 percent in infrastructure. Overall, we can say that about 47 percent of assets were held in risky investments including stocks and alternatives. Public pension funds around the world were a bit more conservative in their investments, holding only about 44 percent of their portfolios in risky assets.

Now consider U.S. state and local government pension funds: according to the [Public Funds Survey](#), the average U.S. public pension currently holds 73 percent of its portfolio in risky investments. There is no reason for state and local plans to take so much risk except to exploit lax GASB accounting rules that allow pensions that take more risk to reduce their contributions.

Moreover, state and local plans have shifted toward riskier investments, even since the Great Recession, as a way to keep their assumed investment returns high and their contributions low. Since 2001, the yield on Treasuries has fallen by about 2.3 percentage points while the assumed return on state and local pension investments has fallen by only around 0.3 percentage points. Plans have kept assumed returns high by taking more investment risk, especially in terms of private equity and hedge funds.

Simply put, the use of GASB's "expected return" discount rate to calculate public employee pension liabilities both deceives purchasers of state and local government bonds and introduces excessive risk-taking into state and local finance. If Puerto Rico's pension system is considered "too big to fail," what do we think would happen if any of Illinois' public employee plans became insolvent?

The Puerto Rico rescue legislation gives Congress the opportunity to act in a way that protects consumers and public finances without unduly imposing federal government power on state and local governments. Any Puerto Rico legislation should include the provisions of the Public Employee Pension Transparency Act (PEPTA), which was first introduced by California Rep. Devin Nunes in 2011. PEPTA would require that state and local pensions disclose their liabilities calculated using the yield on U.S. Treasury securities. This is a simple calculation that any plan actuary could perform at practically zero cost. PEPTA has been co-sponsored in the House by now-Speaker Paul Ryan and garnered support from the bond ratings agency Moody's. State and local pensions could measure liabilities for their own purposes however they want and they can fund their pensions however they want. But buyers of municipal bonds deserve an honest view of state and local governments' true pension liabilities.

Accurate pension liability disclosure is a market-friendly way to increase responsibility in state and local government financing. Given an honest view of public pension liabilities, borrowers will reward governments that responsibly fund their pensions by putting aside more money and taking less investment risk, while penalizing the governments who play fast and loose. Improved disclosure would benefit bond buyers and anyone else who cares about getting an accurate picture of state and local government finance. This requirement seems little to ask of state and local governments given the federal government's favorable tax treatment of retirement plan contributions and the federal tax exemption granted to state and local government bonds, an exemption that allows those governments to issue debt at lower cost.

Puerto Rico rescue legislation introduced last December by Sens. Orin Hatch (R-UT), Lisa Murkowski (R-AK) and Charles Grassley (R-IA) — the chairmen of the Senate Committees on Finance, Energy and Natural Resources, and the Judiciary, respectively — contained pension liabilities disclosures that draws on Nunes' proposal. Any eventual Puerto Rico legislation should retain those disclosure requirements. Congress can act now on public employee pension financing through better disclosure. The alternative may be a federal taxpayer bailout of state and local pensions in the future. Take your pick.

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