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Battered by Great Recession, Underfunded Public Pensions to Persist.

CHICAGO — Ten years on from the financial crisis, many U.S. state and local public pension systems are still the worse for wear.

Investment returns have been uneven and funding levels have yet to recover. Many pension funds have meanwhile attempted to boost returns by loading up on alternative investments to levels unheard of a decade earlier.

“Some just cannot grow their way out of it. We have had several years of stellar (stock market) returns and it barely improved the underfunding situation,” said Mikhail Foux, municipal credit analyst at Barclays in New York.

The benchmark S&P 500 U.S. stock index has tripled in the past nine years, driven in part by unprecedented zero interest rate policies and massive monetary stimulus from central banks around the globe aimed at combating the deepest recession in a generation.

But pension returns struggled to match the broad market, and recent wobbles in U.S. equities have fed fears of another downturn.

“Now what happens when markets are falling 10 to 15 percent?” Foux asked.

For an interactive graphic on public pension plan funded levels, click: http://tmsnrt.rs/2tPyAFf

In 2007, a year before the crisis began, the median funded level was 92 percent for state retirement and 97 percent for local plans, according to Wilshire Funding Studies. That fell to 68 percent for states and 72 percent for local governments by 2016, the most recent data.

A lower funded ratio indicates the overall soundness of a pension fund is weaker and more money is required to meet future obligations.

EXPOSED

Persistently low post-crisis interest rates meant pension funds could no longer depend to the same degree on fixed income to help meet withdrawal demands of an aging pensioner population.

“When the crisis hit, it exposed the kind of precarious nature of the status of plans,” said Jean-Pierre Aubry, state and local research director at Boston College’s Center for Retirement Research.

Even with U.S. rates inching higher since 2016 and stocks mounting record highs, pensions still struggled to generate consistent returns.

For an interactive graphic on public pension annual median returns, click: http://tmsnrt.rs/2tRGptV

The number of active public sector workers per retiree has been falling. That ratio declined to 1.42

in 2016 from 2.43 in 2001, according to a November 2017 National Association of State Retirement Administrators (NASRA) Public Fund Survey. That can boost pension costs when combined with a poorly funded plan.

For an interactive graphic of state and local government pension plan membership, click: http://tmsnrt.rs/2oZwAVq

RISK TAKERS

The sharp economic downturn that accompanied the 2007-2009 financial crisis weighed on core tax revenue, leading governments to pursue an unprecedented amount of reform measures to shore up pensions by boosting contributions and cutting benefits.

“Just as these pension funds required higher contributions as a result of the market decline, the plan sponsors were less able to pay those higher contributions,” said Keith Brainard, NASRA’s research director.

That prompted retirement systems to turn to riskier alternative investments such as hedge funds, private equity, real estate and commodities to pad returns.

U.S. public pension funds became the biggest risk-takers among pension funds internationally, according to one academic study updated in February 2017.

To read the study, click: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2070054

Alternative investment allocations jumped to 24 percent in 2015 from 9 percent in 2005, according the Center for Retirement Research.

“We know for the most part that alternatives have not been the panacea since the financial crisis,” Aubry, noting that hedge funds and commodities have underperformed equities during that period.

Public pension funds’ assumed rates of investment return have trended lower since the crisis. If a plan’s returns fall below that expected rate, government sponsors need to make up for the loss.

But public plans in general have tended to lag private-sector pension plans in lowering those discount rates, according to data cited by New York’s Rockefeller Institute of Government last year.

Between 1993 and 2012, as 10-year U.S Treasury yields fell by 4.3 percentage points, large private-sector U.S. plans reduced their discount rates to 4.4 percent from 8.2 percent.

For large public plans for funding purposes, the rate only fell from 7.8 percent to 7.7 percent in the same period, according to the institute’s report.

LEGAL BATTLES

In the years since the crisis it has proven difficult for some governments to modify retirement benefits, and legal wranglings are ongoing.

Legal or political constraints have stymied changes in states like Illinois, Kentucky and New Jersey, where contributions have lagged actuarially required levels for decades.

Lawsuits filed against more than 40 state and local governments since 2008 contested pension changes on constitutional grounds, according to the Laura and John Arnold Foundation, which tracks the litigation.

Courts in 13 states have upheld reductions in cost-of-living adjustments (COLA) for retirees' pension payments, but have struck reductions down in four.

In California, long-standing judicial rulings prohibiting the state and local governments from reducing benefits will be tested in three lawsuits before the state supreme court, according to Stuart Buck, the Arnold Foundation's vice president of research.

By REUTERS

MARCH 26, 2018, 1:17 A.M. E.D.T.

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