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Making U.S. Pensions Honest About Returns Means Bigger Deficits.

Oregon taxpayers and retired public employees will have to dig a little deeper to pay for the state pension's decision to be more honest about investment returns.

The Oregon Public Employee Retirement System on July 31 reduced its forecast for how much it expects to earn next year to 7.5 percent from 7.75 percent, increasing the hole to be filled by taxpayers and state workers by \$1.7 billion to \$73.4 billion, according to state data.

States and cities have been shortchanging pensions for decades, as high return assumptions lowered the amount of tax money needed each year to finance the plans. The funds, already \$1.4 trillion short, according to the Federal Reserve, face scrutiny for too-optimistic assumptions as markets have become more volatile since the 2008 global financial crisis.

An "assumed rate of return" is used to predict how much a pension has set aside to pay retirees. Too high a rate leads to a false impression of a pension's ability to pay. The average assumed return in the U.S. is 7.68 percent, according to the National Association of State Retirement Administrators.

"The use of such high assumptions is deceptive because it keeps the funded level looking higher than it should be," said David Crane, public policy lecturer at Stanford University who worked as an adviser to former California Governor Arnold Schwarzenegger. "Too high a return is dishonest."

Decades Old

State worker pensions from New York to California are considering or have cut targets. Since 2008 more than half the 126 pensions tracked by the retirement administrators' association have cut assumptions at least once.

Pensions projection returns are based on estimates in place since the 1980s, said Matthew Smith, state actuary for Washington, who has been working with lawmakers to gradually lower the assumed rate of return from 8 percent to 7.8 percent and more in coming years. The rate of inflation has slowed and fixed-income yields have hovered near record lows since the Fed began providing unprecedented monetary stimulus during the recession that ended in 2009. Public pensions earned 3.4 percent during the past year, the weakest since 2012.

"Conditions that led to large market returns in the 1980s and 1990s no longer exist," said Smith. "It is not reasonable to look at 30 or 40 years of returns and assume they will continue."

Biggest Funds

The California Public Employees' Retirement System and New York State Common Retirement Fund, two of the largest public pensions in the U.S., are considering whether to cut forecasts for returns. Texas Municipal Retirement System cut its forecast to 6.75 percent from 7 percent in July.

Calpers, at \$300 billion the largest public pension in the U.S., reported in July that it earned 2.4 percent in its last fiscal year, less than one-third its 7.5 percent target. The fund's board may consider slowly cutting its rate to 6.5 percent as part of a plan to reduce risk, according to fund documents.

The expected rate doesn't affect how much is owed to retirees, and missing a target one year doesn't mean a pension won't be able to pay benefits, but consistently performing worse than expected increases funding pressure. That adds to stress of governments that recently saw tax revenue restored to levels not seen since before the recession.

"A lower rate of return can force issuers to face up to their funding commitments," said Tom Aaron, vice president with Moody's Investors Service.

Contribution Adjustment

Governments that fail to meet assumed returns face a rising unfunded liability unless they make up the difference with higher contributions or reduced benefits.

That can put pressure on other budget items, such as debt services. Pensioners fared better than bondholders in Detroit's 2013 bankruptcy.

"Lower return assumptions mean the issuer has to put more cash into the pension, to the detriment of other expenditures, like debt service," said Matt Fabian, partner at Concord, Massachusetts-based Municipal Market Analytics, a municipal bond research firm.

Dallas's fire and police pension saw its shortfall more than triple to \$4.7 billion, Moody's said in July after the city cut its estimate, putting the pension in a position of needing more money.

"Pensions will have to line up for money for debt and operations when you cut estimated returns," said Richard Ciccarone, president and chief executive officer of Chicago-based municipal finance analysts Merritt Research Services.

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