Bond Case Briefs

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Study Finds Public Pension Promises Exceed Ability to Pay.

When Detroit went bankrupt in 2013, investors were shocked to learn that the city had promised pensions worth billions more than anyone knew — creating a financial pileup that ultimately meant big, unexpected losses for Detroit's bondholders.

Now, researchers at Citigroup say the groundwork has been laid for similar conflicts across the developed world: Governments have promised much more than they can most likely pay to current and future retirees, without revealing the disparity to investors who bought government bonds and whose investments could be at risk.

Twenty countries of the Organization for Economic Cooperation and Development have promised their retirees a total $78 trillion, much of it unfunded, according to the Citigroup report.

That is close to twice the $44 trillion total national debt of those 20 countries, and the pension obligations are "not on government balance sheets," Citigroup said.

"Total global government debt may be three times as large as people currently think it is," the researchers warned, after gathering as much information as they could about various government pension plans and adjusting the amounts where necessary, to permit fair comparisons with bond debt.

Getting each country's unstated pension obligations down on paper, along with the sovereign debt, showed that some countries have almost certainly promised more than they can deliver.

"If you owed student loans of $44,000, and the bank called you up and said, 'actually you owe $134,000,' you'd fall off your chair," said Charles E. F. Millard, head of pension relations at Citigroup. "That's what this is."

He said he did not expect all the overextended governments to experience sudden head-on collisions between bondholders and pensioners the way Detroit did. Instead, he said many of those countries — as well as many American states, cities, school districts and other jurisdictions — would keep struggling along, cutting more and more services, raising taxes and wondering where all the money was going.

"It's not going to be, for most cities and states, some enormous collision or explosion," he said. "It's going to be 10 fewer cops, or three fewer teachers and 'Let's fix the bridge three years from now.' "

One of the report's recommendations was that governments start disclosing the amounts promised to retirees, "so that everyone can see them."

Government officials are in many cases loath to do that because they believe it will harm their credit ratings, driving up borrowing costs. And the unions that represent public workers believe calls for full disclosure mask a broad anti-labor campaign to cut benefits.

The disclosure issue has grown increasingly contentious in Washington. Republican members of

Congress are planning to introduce a bill in the next few days that would require states and local governments to measure their pension obligations using the method now universally used to price municipal bonds. States and cities currently report their pension obligations as calculated by actuaries, and actuarial numbers can greatly distort economic reality.

It was actuarial numbers in Detroit, for instance, that obscured the value of that city's pension promises before the bankruptcy.

States have long argued that as constitutional sovereigns, they cannot be forced to meet any federal pension disclosure requirements. Republican lawmakers are generally sympathetic to states' rights issues, but they are also worried about being asked to bail out troubled pension systems in places like Illinois and Puerto Rico.

Since the tax-exempt treatment of municipal bonds is, in fact, a federal subsidy, they have written the bill to require full, market-based pension disclosure only in connection with tax-exempt borrowing. If states and cities remain unwilling to reveal their pension obligations, they could still borrow — but they could not market their bonds as tax-exempt.

Senate Republicans introduced a similar disclosure measure late last year as part of a package to help Puerto Rico through a huge debt crisis. The island appears not to have nearly enough money to pay both its bond debt and its retirees' pensions, but up-to-date information about its pension system does not exist in the public domain.

For years there have been frequent reports of pension systems rife with pay-to-play deals, improper payouts, overly risky investment strategies and other problems. But the Citigroup researchers looked beyond such scandals and depicted the worldwide accumulation of giant, invisible pension obligations as a matter of simple demographics.

Most developed countries had baby booms after World War II, and their populations are now aging and enjoying significant gains in health and longevity. When the boomers first joined the work force, they provided a big supply of labor to support what was then a much smaller population of retirees drawing pensions. Those favorable demographics made it seem that government pension systems could operate forever with minimal funding — or in many cases, no funding at all.

Now that is changing as populations age in many places, and the Citigroup report said the numbers no longer work. More and more retirees are receiving benefit payments every month, straining retirement systems even when the individual amounts paid are modest. And now there are relatively fewer younger workers generating the revenue that is supposed to support those systems.

The report said these demographic strains would worsen in the next few decades, noting that China now has seven workers to support every retiree, but will have only two by 2050; Japan is on track to have just one per retiree by then.

Citigroup said governments were aware of these trends, but had generally been slow to adapt their retirement systems. It expressed particular concern about pay-as-you-go systems, which are common in Europe.

In a few deeply troubled American jurisdictions, pension systems that were supposed to be funded have exhausted all their assets and effectively become pay-as-you-go plans, in which payments come from current tax revenues rather than dedicated, invested funds. Puerto Rico now looms as the biggest case — but while Puerto Rico's financial troubles are widely seen as an aberration, the Citigroup research suggested they were not.

“Future population and life expectancy trends will exert considerable pressure on public and private sector pension systems,” the report said. “Unless addressed quickly, we believe this could overwhelm public and private sector balance sheets, and act as a major drag on economic growth.”

The report discussed possible solutions, such as “collective defined contribution plans,” in which workers’ nest eggs are pooled and professionally invested, but retirees are not promised a predetermined benefit, and taxpayers are not required to replace money lost on Wall Street.

THE NEW YORK TIMES

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MARCH 17, 2016