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Pension Funds Will Take a Big Coronavirus Hit.

Retirees will have to accept sharply reduced benefits that are more in line with what they would get from Social Security and Medicare.

The coronavirus crisis is still unfolding, but it's not too soon to think about lasting financial impact and how to limit the fallout. One major financial crisis that may hit later this year or early in 2021 is the ever-looming collapse in state and local employee pension funds. Although the problem has been growing for decades, the virus may have been the event that pushed it over the edge.

Declines in the financial markets may have cost the funds as much as $1 trillion in assets, or about 25% of their total, according to Moody's Investors Service. That would bring the aggregate funding ratio—value of assets divided by actuarial value of liabilities—from 52% based on the last report by the Census Bureau down to perhaps 37%. Markets may recover, of course, but they may not. The latest aggregate numbers we have are from 2017, and for most individual funds data is available only as of mid-2018. Asset returns are usually smoothed so it could be four or five years until the full effect of the virus is reported officially.

But it's not aggregate numbers or official reports that will trigger a crisis. It's the big funds in the worst shape. My back-of-the-envelope calculations suggest Connecticut could be looking at a 28% funded percentage if the numbers were available now, Kentucky 25%, New Jersey 24% and Illinois 20%.

Those figures rely on optimistic assumptions about healthcare cost increases and discount rates; the true numbers are probably worse. The important statistic is more objective: how many years' benefits do the pension assets represent? That could be no more than about four years in Illinois if true numbers were public today, five in New Jersey and Kentucky, six in Connecticut.

All benefits for active employees, plus all benefits for everyone in the near future, will have to come from employee or state contributions. But states will be strapped for cash, and looking to cut contributions, not raise them. Employees will be unwilling to contribute more since there's little likelihood they'll ever see that money again, especially as post-2008 reforms have denied many of them the gold-plated benefits that employees with more seniority enjoy.

Taxpayers? The least willing of the bunch. Creditors? The states need to keep borrowing money, so they have to appease creditors. Some of the money will come via defaults or restructuring of state and local debts, but this is its own crisis, and it won't fill the gap. The federal government? Maybe, but not for full payments. A more likely scenario would be absorbing retirees into Social Security and Medicare at sharply reduced benefit levels—and those programs face similar problems as state and local plans.

It's true that 48 states have constitutional or other legal protections for pension benefits. These will improve union bargaining power, but it won't squeeze anywhere near the full amounts promised. Courts will both unwilling and unable to force governments to hand over money the governments don't have and can't get.

Will deaths tied to the Covid-19 pandemic save the day? After all, deaths will likely be concentrated among retired employees getting benefits rather than active employees paying contributions. Moreover, active employees who succumb to the virus will be replaced. If we exclude Hollywood disaster scenarios, the highest projections are U.S. death rates doubling in 2020 and remaining 2.5% higher thereafter. Using the age distribution of coronavirus deaths for which information is available, that could cause liabilities to fall by about half the amount that assets fell. But in that scenario assets would probably fall much farther. It’s hard to come up with a scenario in which additional coronavirus deaths improve pension funded ratios.

Will these events trigger Illinois or some other state to default? It’s plausible. Will that cause other states and municipalities to follow? That’s likely, mainly because creditors will stop lending to states with big unfunded pension liabilities. Will that provide the cover for every state except maybe Utah and Wisconsin from seizing the opportunity to renege on promises? I’d bet on that as well.

What we do today is start treating pensions as an issue that must be addressed rather than a can to be kicked down the road. Admit that promises to employees will not be kept, and start figuring out how to direct the cuts to where they will do the least harm: younger workers with more time to prepare and richer workers with more ability to pay. Collecting the maximum contributions possible, but in realistic forms employees can count on rather than unreliable promises about future. Releasing timely and complete data on assets and cash flows.

The basic terms of the fix are obvious. Pension payments will be capped, probably at something like the Social Security maximum of $3,011 per month for someone who retires at age 65. Tax the benefits, again probably like the rules for Social Security (50% of benefits for single filers with total income between $25,000 and $34,000, 85% of benefits for higher income individuals). Make healthcare plans more Medicare-like, with lower provider payments. Employee contributions to be directed either to Social Security/Medicare or individual retirement accounts rather than underwriting payments to retired workers.

This will provoke fierce fights. First to accept the inevitable and second to set the precise terms. How will police officers be treated versus teachers versus Division of Motor Vehicle clerks? Will all state and local plans be put in one bucket, or will employees from more prudent states do better than employees from profligate ones? How will scarce funds be directed to pensions versus health benefits? How much will taxpayers and creditors kick in? These fights will take place in legislatures, courtrooms and union elections. It won’t be pretty or fun. But the sooner we admit the problem and start to solve it, the sooner it’s behind us.

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By Aaron Brown

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