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Underfunded Public Plans Facing a New Round of Woes.

The coronavirus has increased pressure on underfunded public pension plans that were already facing significant stress before the crisis.

Not only have plans' investment portfolios taken double-digit losses as a result of the pandemic, but government plan sponsors will need to increase their contributions at a time when revenues are down and expenditures are up.

"This has put a lot of strain and stress on pension deficits, and it's going to get worse," said Kevin McLaughlin, head of liability risk management at Insight Investment. "Pressures that were there before are now magnifying. It's quite worrying."

The pandemic has unleashed havoc on markets — and plans' portfolios. Moody's Investors Service estimates that U.S. public plans are generally on pace for an average investment loss of about 21% for the fiscal year ending June 30.

A report issued March 24 by the New York-based credit ratings agency noted that domestic public plans are facing nearly $1 trillion in investment losses because of the economic fallout from the coronavirus. These losses could exacerbate the pension liability challenges that many state and local governments already are facing. Plus, the economic setback is reducing revenue levels and threatening the ability of state and local governments to afford higher pension costs.

"Without a significant market rebound, that's going to result in some new unfunded liabilities that are going to be material and compounded on top of the already unfunded liabilities," said Tom Aaron, vice president and senior analyst at Moody's in an interview. "This will push up government contribution requirements."

Mr. Aaron added that, "given the already unfunded positions, if governments don't quickly increase their contributions, the longer-term consequences for pensions are severe."

Of the 181 public plans tracked by the Center for Retirement Research at Boston College, National Association of State Retirement Administrators and the Center for State and Local Government Excellence, 31 have funding ratios that are below 60%.

And while American Enterprise Institute resident scholar Andrew G. Biggs agreed that state and local governments should increase their contributions after public plans took "a big hit on their assets," he said that he wouldn't be surprised if governments failed to make their full contributions this year, given the massive costs associated with responding to COVID-19.

"The coronavirus wasn't predicted. But for years outsiders have warned that public-sector pensions have contributed too little, taken too much investment risk and failed to enact sufficiently far-reaching reforms," Mr. Biggs added in an email. "It was only a matter of time before something went wrong."

Budget effects

Another question the crisis poses is how the budgets of public plans will be affected.

“From a liquidity perspective, public funds have two sources to pay for benefits: existing assets and existing contributions,” said Greg Mennis, director of public sector retirement systems for Pew Charitable Trusts in Washington. “For underfunded plans, current inflows are very important.”

Mr. Mennis said that states like Connecticut and Illinois, which are already making large contributions to their plans, are better positioned to maintain liquidity and work toward their target asset allocation. But a state like New Jersey, which he said has the lowest rate of cash flow among any state, is more at risk.

Some plans facing funding challenges have been preparing for a disruption in the markets. And although none of them could expect a crisis such as COVID-19, they said they are at least better positioned to handle the resulting market volatility.

Shawn T. Wooden, state treasurer and principal fiduciary of the $37 billion Connecticut Retirement Plans & Trust Funds, Hartford, said in a phone interview that he came into office “with a clear sense that the market wasn’t going to continue to roar for the next decade.”

To prepare the portfolio for a downturn, Mr. Wooden’s investment team lowered the state’s $18.7 billion Teachers’ Retirement System’s assumed rate of return to 6.9% from 8%, decreasing its exposure to global equities while increasing its allocation to fixed income and hiring a chief risk officer to monitor risk across the entire portfolio.

The state’s TRS has a funded status of 58%, while Connecticut’s State Employees Retirement System is 38% funded.

Chicago Public School Teachers’ Pension & Retirement Fund also took steps before the crisis to make its portfolio more defensive in anticipation of a market downturn.

“We’ve been in this cycle for 10-plus years, and we knew at some point something would happen, we just didn’t know it would be at this magnitude,” said Angela Miller-May, CIO of the $10.5 billion pension plan. CTPF’s funded status is 47.9% and the expected rate of return is 7%.

Ms. Miller-May said that the board does not expect the funded status to change as a result of COVID-19.

Funding challenge

Because of its challenged funded status, Rich Robben, CIO of Kentucky Retirement Systems, Frankfort, said that the $16.8 billion pension fund went into the crisis with an already conservative asset allocation (overweight to core fixed income) and about $3 billion of dry powder.

“We were very fortunate with our liquidity position going in,” Mr. Robben added.

The funded status for Kentucky’s pension system is 32.8%. David Eager, executive director for KRS, said he “would expect the funded statuses to fall somewhat but not drastically since the asset structure is quite conservative.”

The actions of these underfunded plans are in line with the expectations of Alex Brown, NASRA’s research manager, in Washington.

“Pension plans that are poorly funded don’t necessarily behave differently than other plans,” Mr.

Brown said. “They have policies in place that take their funding position into account.”

Meanwhile, New Jersey Treasurer Elizabeth Maher Muoio warned bondholders in a voluntary disclosure statement issued on March 23 that the impact of COVID-19 on New Jersey will produce “precipitous declines in revenues” for the current fiscal year ending June 30 as well as the next fiscal year affecting “revenue collections and pension funds contributions.”

Still, Assistant Treasurer Dini Ajmani said at the State Investment Council meeting on March 25 that the state remained committed to making its fiscal third- and fourth-quarter contributions to the $74.2 billion New Jersey Pension Fund, Trenton.

Following Ms. Muoio’s warning, the state’s top leaders issued a joint statement on April 1 stating they plan to push back the current fiscal year-end to Sept. 30 from June 30.

Have enough cash

Investment consultants with whom Pensions & Investments spoke said the plans they’ve worked with are not repositioning their portfolios and already have enough cash to pay out obligations.

Jay V. Kloepfer, executive vice president and director of capital markets research at San Francisco-based investment consultant Callan LLC, said that plans, even underfunded ones, “shouldn’t be making sudden changes.”

“You shouldn’t be changing the wheels of the car while you’re driving down the road,” he said, adding that the big question plans should ask themselves is if they have enough liquidity. But based on the conversations he’s had with clients, that hasn’t been an issue.

“We’ve addressed liquidity pretty aggressively with most plans we’ve worked with, especially those in a challenged funding position.”

Kristen Doyle, a partner and head of public funds at Aon PLC’s investment consulting business, said that many plans, particularly underfunded ones, “have a healthy allocation to investment-grade credit and cash, so parts of their portfolios will remain liquid.”

“Allocations are based on funded status. They test these different portfolios against that liability structure and test it across multiple markets, including ones like this one,” Ms. Doyle explained.

She added that the plans she’s worked with aren’t panicking, and those that are rebalancing are doing so “very carefully and prudently.”

“The plans we work with are pretty well-positioned,” Ms. Doyle said. “They have a strong risk-reducing allocation that’s liquid. And all of these plans typically have a robust process in place in where they’re managing their cash flow on a monthly or more regular basis.”

Pension obligation bonds

While revenues are down at a time when contributions need to be up, the pension obligation bond is another option that government sponsors of underfunded plans can use.

Girard Miller, a retired investment and public finance professional and former CIO of the $17.3 billion Orange County Employees Retirement System, Santa Ana, Calif., said that the pension obligation bond is a temporary measure that could put the underfunded pension plan “on firm footing.”

“They only work well if they’re issued in the depths of a recession. Now is the time for that,” Mr. Miller said. “The plan sponsor has a liability with this, but they can stretch that out over 30 years if they need to.” The cost of doing this is lower than the traditional way, so there is potential for some cost savings for the state.

But not everyone agrees.

“I don’t think (pension obligation bonds are) an option in this market right now,” Ms. Doyle said. “It’s a risky endeavor because you’re assuming the pension will outperform the interest rate of the bond, and that’s a huge gamble.”

Going forward, increased contributions alone will not keep struggling plans afloat.

“It will have to come down to structural reform,” Karel Citroen, head of municipal research at Conning said. “I just don’t see how you’re going to address pension funding issues you see in this country without addressing the entitlement side of it.”

Mr. Citroen pointed out that, if it’s not possible to make such changes for current plan participants, structural changes should be put in place for new or future plan participants.

Mr. Citroen added that “it will probably come down to an escalation of this issue for one plan, like New Jersey or Illinois, for that mindset to be accepted by other constituents as well.”

While Insight’s Mr. McLaughlin said that underfunded plans will have to engage in “firefighting” to ensure they have enough cash on hand to pay their obligations in the short term, in the long term, plans will need to craft a “liquidity strategy that’s more formal than they’ve had in the past.”

“When the dust settles, you’ll see plans making more fundamental changes to their investment strategies going forward,” Mr. McLaughlin added.

NASRA’s Mr. Brown said it’s going to take a while before the long-term impact of all of this is known.

“One should remember that these losses and gains are phased in over several years,” Mr. Brown said. “We won’t know what the returns will be until the fiscal year ends, and so it’s going to take a little while.”

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by JAMES COMTOIS

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