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The US public pensions crisis 'is really hard to fix'

Attracta Mooney

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Chicago's public pension system has an estimated funding hole of between $20bn and $32.5bn

Eighteen months after Rahm Emanuel, a former White House chief of staff, became mayor of Chicago, he addressed a news conference about his priorities.

"[Number] one is retirement security and pension reform so we can give taxpayers and the public employees retirement security, which is something we can't say today," the mayor said in November 2012.

In the following three and a half years, Chicago's public pension system, which estimates suggest has a funding hole of between $20bn and $32.5bn, has cast a long shadow over the mayor.

There have been rows with unions, court battles and finally a credit downgrade for the city, all linked to the Chicago's public pensions.

Similar stories are playing out across the US. Although the funding deficits might not be as extreme as in Chicago, many cities and states are struggling under the weight of their pension plans, which oversee the retirement incomes of current and past public sector employees.

The scale of this pension crisis, as it has been dubbed, is huge. The Hoover Institution, a think-tank at Stanford University, estimates that US public pensions collectively have a $3.4tn funding hole. More conservative numbers put the funding gap at around $1tn.

Few public pension plans are fully funded, meaning they do not have enough money to pay current and future retirees. And the situation is getting worse.

According to Wilshire Consulting, an investment advisory company, state-sponsored pension plans in the US had just 73 per cent of the assets they needed in mid-2015, down from 77 per cent in 2014. Turbulent market conditions in the latter part of 2015 and early 2016 probably made this number even worse.

The big questions are if and how the large funding holes that have emerged in the US public pension system can be fixed.

Chris Tobe, an investment consultant and author of Kentucky Fried Pensions, a book examining problems in Kentucky's retirement system, says the shortfalls in most US public pension plans are fixable, but there are exceptions, such as Chicago.

However, fixing the schemes will require a lot of work and is likely to have unpleasant consequences for retirees, employees, taxpayers and politicians.

One area where this is apparent is when state and local governments increase or introduce taxes, using the money raised to plug pension shortfalls. Several cities, including Chicago and Philadelphia, have taken this route.

But higher taxes or the issuance of bonds, another option used by local governments to raise money in order to reduce pension deficits, often proves unpopular with taxpayers.

Tamara Burden, principal at Milliman Financial Risk Management, an investment adviser to pension funds, says: "Raising taxes and issuing bonds means a vote, and a lot of public entities have seen those initiatives not pass.

"[The large-scale underfunding of public pensions] is really hard to fix."

In Chicago, Ed Bachrach, chairman of the Center for Pension Integrity, a non-profit organisation, estimates that to ensure the city's pension plans are fully funded within 20 years, Chicago's property tax would have to be increased 85 per cent. But he warns that "crippling tax increases" could drive taxpayers and businesses away.

Mr Bachrach adds: "In troubled jurisdictions, officials cannot raise taxes fast enough to prevent the erosion of fund assets, and the enormous pension payments required are crowding out expenditure for vital public services and crumbling infrastructure."

There are other options available to improve the outlook for public pension plans. One is making changes within pension funds that would help to drive funding deficits down, such as cutting the fees retirement plans pay to asset managers. Some pensions are pushing into riskier assets in the hope that this will increase returns.

Alternatively, state and local governments could reduce benefits for current or future retirees, or cap the maximum retirement benefit that can be paid to an individual. These measures are illegal in some states and have proved unpopular with unions and public sector workers.

Public sector workers could also be forced to increase their contributions, or moved into defined contribution plans, which do not guarantee a level of income on retirement. This would, in turn, reduce the strain on local government budgets.

Any attempt to fix the pension shortfall is likely to involve a combination of these solutions. But there seems to be an unwillingness to fix the problems, according to Olivia Mitchell, a professor at the Wharton School at the University of Pennsylvania.

Unions, public sector employees and retirees do not want to give up the benefits promised to them, politicians do not want to impose tax hikes that could cost them votes, and taxpayers are reluctant to part with more cash to prop up the system.

Ms Mitchell says: "Politicians and taxpayers have shown themselves unwilling to take their public pension shortfalls seriously.”

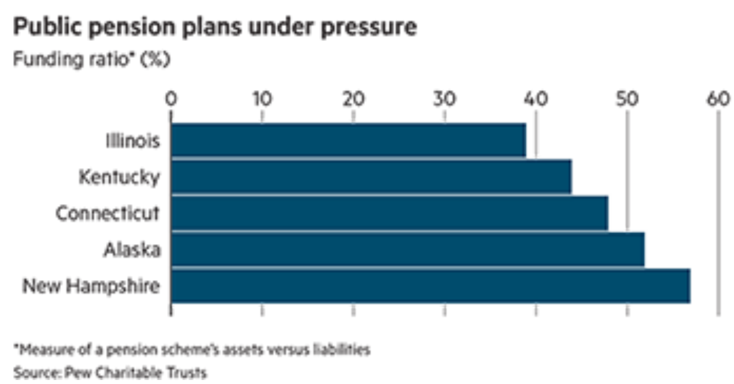
Mr Bachrach adds: “Fixing this problem requires shared sacrifice from all parties: public employees, retirees and taxpayers. It requires courage on the part of elected officials.”

If the problems are not fixed, the consequences could be dire.

Some pension funds, including two of Chicago’s plans, are on course to run out of money within a matter of years. This means that either the retirees will not get paid the money they are owed, or, more likely, the cities and states that back the pension plans will have to cover the retirement payments.

This would leave cities and states with less money to spend on services such as education. In some cases, cities may go bankrupt. This has already happened in Detroit in Michigan and San Bernardino in California, where large public pension shortfalls contributed to the cities’ defaults.

“I do believe that US cities and towns will continue to suffer [because of their pension funding holes], and there will be additional bankruptcies following the examples of Detroit,” said Ms Mitchell earlier this year.



Some pension officials are hoping the federal government will step in and prop up problematic retirement funds. But Devin Nunes, a US Republican congressman, is trying to make sure this does not happen.

He proposed a bill in March to ensure the federal government cannot rescue insolvent public pension funds. “Cities and states should run [pension funds] in a financially sustainable way. That is what my bill encourages, particularly by prohibiting federal bailouts of distressed funds,” he says.

Even without the bill, Steven Hess, an analyst at Moody’s, the rating agency, says states and cities will have to fix their own pension problems. “We don’t think the federal government will come to the rescue of municipal plans,” he says.

Phil Angelides, a former state treasurer for California who used to sit on the board of Calpers and Calstrs, the US public pension schemes, says: “[The public pension deficit] is manageable if society begins to address it. A few pension funds may have immediate issues, but they face long-term challenges and there is still time to address them.”

As for Chicago, the future of its pension funds remains unclear. In March, Illinois’s Supreme Court ruled against Mr Emanuel’s plans to stabilise the pension funds by requiring larger employee contributions and cutting pension benefits in return for bigger contributions from the city.

In the wake of this ruling, a spokesperson for the mayor says: “We are currently evaluating a number of pension reform proposals.”

The mayor, it seems, faces an uphill battle to plug the city’s pension deficit.

US public pensions: ‘There is no young blood coming in’

The large funding holes that have emerged at US public pension plans have been decades in the making.

A combination of factors, ranging from demographics to current low interest rates, has left pension plans nursing big deficits.

In some cases, cities and state governments have not contributed as much as they should have to public pension plans, leaving funds without the money they needed to invest and plug any developing funding holes.

Another factor is that public pension plans have been underestimating how much money they would need in future, says Olivia Mitchell, a professor at the Wharton School at the University of Pennsylvania.

Public plans typically have high return targets of between 7 and 8 per cent, which are used to forecast how much money a pension fund will need to pay current and future retirees. Private sector pension plans, in contrast, typically use lower rates of 2.5 per cent on average to calculate future liabilities, says Ms Mitchell.

Every time a public pension plan misses the return target, their liabilities jump. They then need far stronger performance the following year in order to correct the problem.

An ageing public sector population is not helping matters. “There is no young blood coming in to keep their plans going,” says Ms Mitchell.