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US faces ‘disastrous’ $3.4tn pension funding hole

Attracta Mooney

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The US public pension system has developed a $3.4tn funding hole that will pile pressure on cities and states to cut spending or raise taxes to avoid Detroit-style bankruptcies.

According to academic research shared exclusively with FTfm, the collective funding shortfall of US public pension funds is three times larger than official figures showed, and is getting bigger.

Devin Nunes, a US Republican congressman, said: “It has been clear for years that many cities and states are critically underfunding their pension programmes and hiding the fiscal holes with accounting tricks.”

Mr Nunes, who put forward a bill to the House of Representatives last month to overhaul how public pension plans report their figures, added: “When these pension funds go insolvent, they will create problems so disastrous that the fund officials assume the federal government will have to bail them out.”

Large pension shortfalls have already played a role in driving several US cities, including Detroit in Michigan and San Bernardino in California, to file for bankruptcy. The fear is other cities will soon become insolvent due to the size of their pension deficits.

Joshua Rauh, a senior fellow at the Hoover Institution, a think-tank, and professor of finance at the Stanford Graduate School of Business, who carried out the study, said: “The pension problems are threatening to consume state and local budgets in the absence of some major changes.

“It is quite likely that over a five to 10-year horizon we are going to see more bankruptcies of cities where the unfunded pension liabilities will play a large role.”

The Stanford study found that the states of Illinois, Arizona, Ohio and Nevada, and the cities of Chicago, Dallas, Houston and El Paso have the largest pension holes compared with their own revenues.

In order to deal with the large funding shortfall, many cities and states will have to increase their contributions to their pension funds, either by raising taxes or cutting spending on vital services.

Olivia Mitchell, a professor at the Wharton School at the University of Pennsylvania, told FTfm last month that US public pension plans face “grave difficulties”.

“I do believe that US cities and towns will continue to suffer, and there will be additional bankruptcies following the examples of Detroit,” she said.

Currently, states and local governments contribute 7.3 per cent of revenues to public pension plans, but this would need to increase to an average of 17.5 per cent of revenues to stop any further rises in the funding gap, the research said.

Several cities and states, including California, Illinois, New Jersey, Chicago and Austin, would need to put at least 20 per cent of their revenues into their pension plans to prevent a rise in their deficits, while Nevada would have to contribute almost 40 per cent.

Mr Rauh’s study claims the “true extent” of funding problems in US public pension system has been obscured because plans calculate both their costs and liabilities on the assumption they will achieve returns of between 7 and 8 per cent a year. The academic believes this rate is “wildly optimistic and unlikely to be achieved”.

Mr Rauh said a more realistic return rate, based on US Treasury bond yields, was around 2-3 per cent a year.

However, Hank Kim, executive director at the National Conference on Public Employee Retirement Systems, a trade association for public pension plans in the US, called Mr Rauh's study a "manipulation of arithmetic".

"The [public pension] plans are in good shape and are headed to being in even better shape," he said.

Mr Kim added that public pension funds set their return targets at 7.5 per cent because that is what they have been able to achieve historically.

US public pensions recorded an average annual return of 7.3 per cent in the 10 years to the end of June 2014, according to Cliffwater, an investment consultancy.

"Over a long-term trend, that 7.5 per cent return rate is absolutely feasible," he said.

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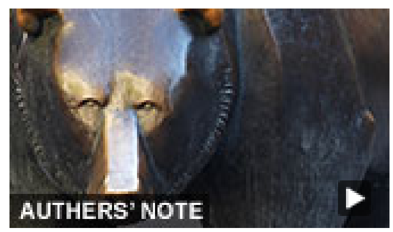

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