Retirement News Highlights

Tuesday, August 18, 2020

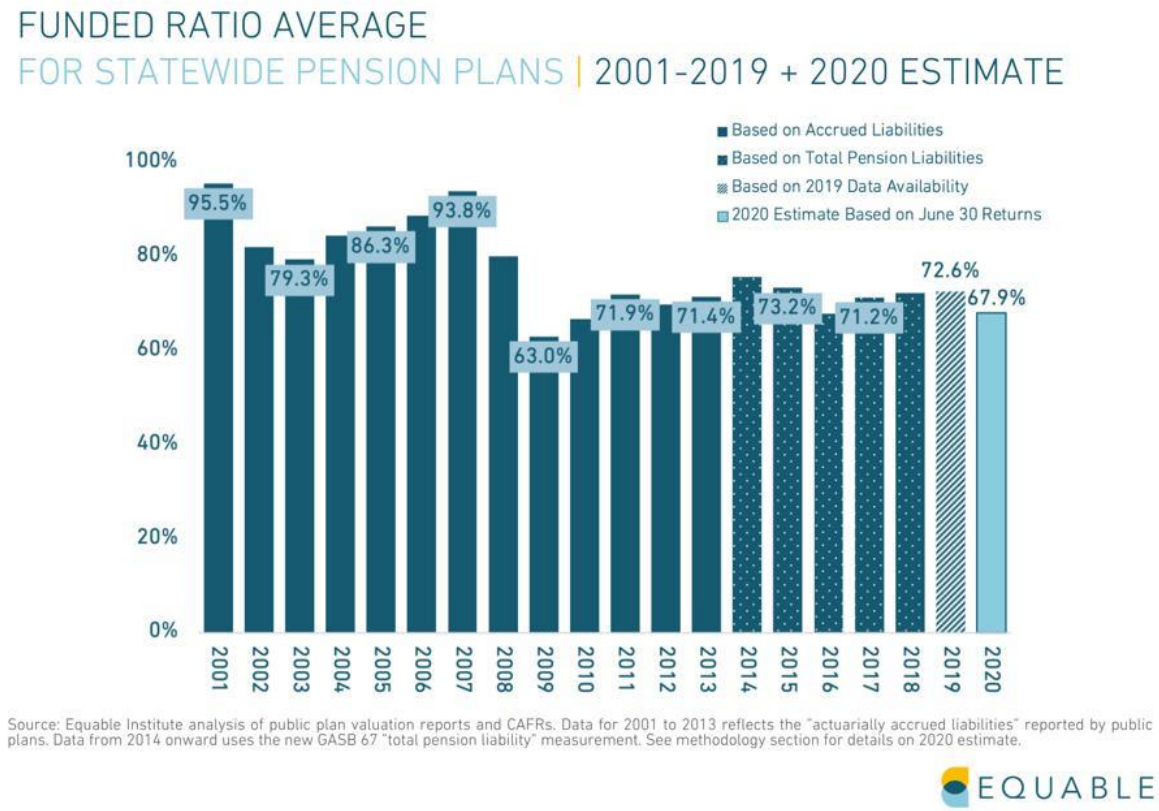
Covid-19 Could Increase States' Pension Debt By $1.6 Trillion

By Liz Farmer
Forbes
August 18, 2020

The S&P 500 hit a new all-time intra-day high on Tuesday, highlighting a dramatic rebound — but the volatile market has left a scar on public pensions this year.

A new report estimates the wild swings driven by the Coronavirus pandemic will amount to a $1.62 trillion loss in 2020. That would bring the total funded ratio across the 50 states to 67.9% — nearly its lowest point in modern history.

The estimates of the Covid-19 impact on pensions come from the Equable Institute, a relatively new nonprofit made up largely of folks who have advocated for pension reforms and cost-saving measures. Most plans haven't actually released their final numbers yet from the past year, so the analysis was done using data from 2019 financial reports and Equable's estimate of plan investment performance.



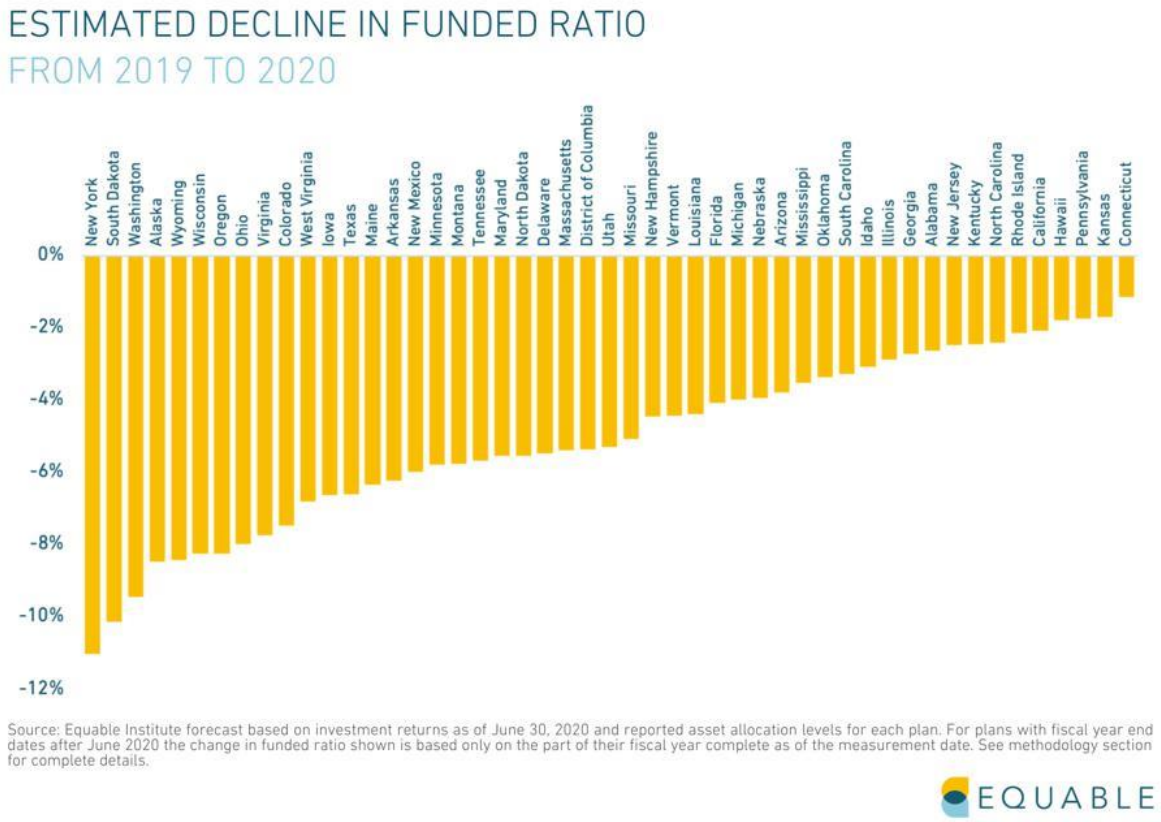
States are already grappling with billion-dollar shortfalls and pensions losses have yet to affect budgets because of the way pensions are funded. Increased pension bills are expected to start in 2021.

New York, South Dakota and Washington states's plans are expected to suffer the largest increases in unfunded liabilities. But that's because they were well-funded, so they had the most to lose.

For example, New York's state pension fund ended its fiscal year on March 31 while the market was still in turmoil. It announced an annual investment loss of 2.7% and a $16 billion drop from last year's fund balance.

But the plan was well-funded — it previously reported about 96% of the assets it needed to meet its total liabilities. To do a quick check on Equable's process, I took New York State's total liability from 2019, measured it up against the new asset balance and got a new funded ratio of 86%. It's a big drop, but when put in the context of the average plan, it's still pretty good. (Equable estimates a slightly larger drop in funded status, likely because it is estimating higher total liabilities than what was last reported.)

So, although the following chart reflects losses, it could also be viewed as a rough proxy for well-funded plans starting with New York state at the top and Connecticut at the bottom.



An important note: the picture might not be as bleak as it appears. For one, most state plans ended their fiscal year on June 30 and were thus able to capture some of the stock market rally of the last few months. Also, Equable appears to be conservative in its estimates. It's numbers are based on an average 0.44% investment return for statewide plans. According to the firm Wilshire Trust Universe Comparison Service, plans with more than $1 billion in assets earned a median return of 3.2% as of June 30.

The bottom line, though, is that pension plan earnings this year will fall far short of where they need to be to keep their funded ratio flat. (The median long-term expected rate of return is 7.25%.)

When plans miss their targets, pension systems' unfunded liabilities — or debt — increases unless governments increase their own annual payments into the system to fill the gap. That has ripple effects for taxpayers because governments unable to stabilize their pensions or afford the increased bills may ultimately lean on them through tax increases or through cuts to services. Many did so after the investment losses of the 2008 financial crash that ultimately wiped out about 25% of public pensions' market value.

Chicago, for example, increased property taxes in 2016 to generate an additional $588 million more per year to put into its pension system. Kentucky, whose state employees' pension plan is less than 17% funded, went the other way and cut spending on things like education and health and human services to redirect money into its retirement system.

The Equable Institute report points out that there is "a theoretical limit to the contribution rates that state leaders will accept" as they consider directing more money from schools and other core services to pensions. At some point, the idea of keeping up with pension debt for some places may be insurmountable: "The larger a state's unfunded liability relative to GDP," the report says, "the harder it will be for that state's tax base to pay down the pension funding shortfall."

Well-funded plans like New York State's or South Dakota's will likely stabilize and improve on their funded ratio, as they did following the losses of the Great Recession.

But many plans never did regain their fiscal health after 2008. Because of the way pension accounting is done, every year a government skimps on a payment or investment returns fall short of expectations, a pension's funded ratio gets worse. Both of these things happened during the Great Recession and the average pension plan ratio fell sharply for four straight years. Beginning in 2013, the national average pension funding ratio stabilized at 72%. But that's where it stayed, even during an economic expansion that saw governments putting more money into pensions and plans exceeding their assumed rate of return six times.

In short, it's easy to lose ground in pension funding. But it's much harder to make it up.

State lawmakers will have to deal with budget shortfalls for at least two more years. Especially for states with "fragile, but not distressed pension plans," Equable advises policymakers to take action on changes to pension benefits "while the costs of doing so are not prohibitively expensive, as is likely the case for states with some of the worse funded plans."

Pensions are highly protected so in most places there is not much more to be done regarding the existing unfunded liabilities. But recent research does suggest that some of the reforms made immediately following the Great Recession are starting to make a difference.

Those changes created less generous benefit tiers for new employees and ultimately lowered newly accrued liabilities. This can "bend the curve," or stabilize government pension payments in the out years.