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No Immediate Pension Hardship For State And Local Governments, But Plenty Of Long-Term Worries

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Table Of Contents

Credit Quality Could Be Hurt If Increased Cost Strains Budgets

A Huge Burden On California

What Governments Can Do

Pension Obligation Bonds May Provide Some Relief

Is It Time To Switch To A Defined Contribution Plan?

Sidebar: OPEBs Are Affordable For Now

Related Research

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No Immediate Pension Hardship For State And Local Governments, But Plenty Of Long-Term Worries

Public pension funds in the U.S. had significant market losses in calendar 2008, but in our view most state and local governments will probably not see substantially higher pension contributions until fiscal 2011 or later. The time lag is due to actuarial smoothing assumptions and the fact that the most severe losses won't be recognized until after the typical fiscal year-end on June 30, 2009. While we believe the pain of these higher costs may not be immediate, some of the potential solutions -- such as higher taxes, increased employee contributions, reduced benefits for new hires, and raising the retirement age – may be difficult and likely unwelcome.

Standard & Poor's Ratings Services believes that governments may have to start increasing their pension contributions as of June 30, 2011, absent what we consider very large investment returns in the next few weeks. Our belief is that most pension funds have not yet calculated the increase in contributions expected for fiscal 2011, but there are some preliminary indications. For example, in April the executive director of the Pennsylvania Public School Employees' Retirement System projected that Pennsylvania school districts might have to raise their contribution to the retirement system to 30.2% in fiscal 2013, from 4.8% of teacher salaries currently, assuming a 30% investment loss in fiscal 2009 and no changes in state law. Arizona's state retirement system has indicated employee contribution rates may have to rise a half percent per year for the next five years, and stay at elevated levels for another five years beyond that.

Credit Quality Could Be Hurt If Increased Cost Strains Budgets

In our view, the impact of increased pension costs on general government credit quality will generally depend on the extent to which these costs grow as a proportion of a public employer's annual budget. Furthermore, the problem is one of steady future increases at a time when municipalities may continue to be strapped for cash because of the effects of the current recession.

We think increased pension contributions will likely phase in gradually beginning in fiscal 2011, due to typical public pension asset smoothing assumptions of five to 15 years. Under accounting rules, governments are allowed to "smooth" asset valuation declines over a number of years for actuarial purposes. This leads to gradual increases in governmental funding following a market decline (see “How ‘Smoothing’ Can Ease the Pain of Pension Fund Losses,” published on Jan. 27, 2009, on RatingsDirect).

Until this year, the funding ratio of public pensions were, in our view, generally strong. In a 2008 survey, the Center for Retirement Research estimated that the aggregate of 125 public pension funds was 86.1% actuarially funded as of fiscal 2007 year-end, while Standard & Poor's report on state pension funds calculated an average state pension funding ratio of 83% (see “Market Declines Will Shake Up U.S. State Pension Funding Stability,” published Feb. 26, 2009).

Public pension funds in the U.S. had a median loss of 24.9% in calendar 2008, according to the Wilshire Trust Universe Comparison Service database of public pension funds. On a five-year basis, the return was 1.95%, according to Wilshire. In our view, this contrasts sharply with the actuarially assumed rate of return of 8% typical

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of most pension funds. The S&P 500 fell 38.5% in calendar 2008, with much of the loss occurring toward year-end. This means that we expect that the first year many pension funds will recognize big losses will be after the current year ending June 30. After evaluation in fiscal 2010, pension contributions will likely begin to ramp up in fiscal 2011 and beyond.

A Huge Burden On California

Most local governments are required by state law to make required pension fund contributions each year. As such, the prospect of steady increases in contributions is of concern to us because many government budgets will likely remain tight for several years. California, which has the lowest rating (A/Stable) of U.S. states due to its budget woes, expects its retirement contributions for all funds to swell to $4.8 billion in fiscal 2010, from $2.4 billion in fiscal 2003. The state expects contributions to rise steadily in future years after taking into account recent investment market losses.

We believe other states and localities will likely see stiff, but manageable, increases in the coming years. In our view, a portion of this increase in pension costs is the result of additional benefits that were granted when investment gains in the late 1990s seemed high enough to support the extra burden. California, for example, boosted retirement pay benefits for its workers in 1999.

What Governments Can Do

We believe some of the ways governments can respond to the prospect of higher future pension contribution costs are:

- Reducing other expenditures or raising taxes, which may be difficult in the current recession.
- Raising employee pension contribution rates, or cutting costs by negotiating a rollback of pension benefits for new hires. These may be hard to do, given generally strong governmental employee unions.
- Raising the retirement age, pushing back the time before full benefits are granted, and/or restricting so-called double dipping by employees who retire from a second government job. For instance, New York City Mayor Michael Bloomberg has proposed a minimum retirement age of 50, and the Nevada legislature is considering raising its minimum retirement age to 62, and requiring 32 years of service for full benefits.
- Delaying pension contributions to stretch out the period of smoothing assumptions, a step Philadelphia is considering. New Jersey is allowing school districts and local governments this year to pay only half of their actuarially required pension contribution.

Pension Obligation Bonds May Provide Some Relief

In our view, one idea that more governments might warm to in a protracted recession is the issuance of pension obligation bonds (POBs). While these must be issued at taxable rates, from a government perspective, POB issuance has the benefit of possibly delaying higher pension contributions for another year or two, as well as enabling the issuer to invest proceeds in the equity market at current levels. Milwaukee County, Wis. recently issued $400 million of POBs, while the city of Jacksonville, Fla., the County of San Luis Obispo, Calif., and Alaska are considering large POB issuances.

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While we believe the sale of POBs last year shortly before the stock-market downturn might have been a bad choice for a local government, we see some fiscal consultants now recommending such a sale based on their view of the upside potential in equities following recent market losses. Several California counties sold POBs in the early 1990s and did well, in our view, with their timing. POBs allow accounting savings to governments to the extent pension fund returns beat actuarial assumptions, with an average assumed rate of return of 8%, according to the Center for Retirement Research's Public Fund Survey. However, we believe it is possible that recent market pullbacks may cause actuaries in the next year or two to recommend reducing the long-term assumed actuarial rate of return, which would lower the projected actuarial savings from POBs.

Standard & Poor's generally considers the issuance of POBs as the swapping of an existing liability for another, with generally neutral credit implications. The difference is that POBs are a "hard" liability with specific repayment dates, and pension contributions are "soft" in the sense that they only need to be adequate to keep a pension fund from insolvency.

Is It Time To Switch To A Defined Contribution Plan?

Finally, some governments may attempt to move from a defined benefit retirement plan to a defined contribution plan, as has been common in the corporate world. This might have an attraction as a way to cut costs, but it appears that the trend, limited as it was to begin with, may be moving in the other direction. Government workers, in our opinion, now seem to desire defined benefit plans even more in light of recent market losses suffered by people with only 401(k) plans. Alaska, for example, was one of the few states to close its defined benefit plan to new hires in 2006 in favor of a defined contribution plan. However, state legislators are now considering moving back to a defined benefit plan due to employee wishes. The West Virginia Teachers Retirement System moved from a defined contribution plan to a defined benefit plan in 2005, and if Alaska follows, Michigan would be the only state with a defined contribution plan.

We are also seeing a limited number of pension funds requesting ratings from Standard & Poor's in order to charge fees for offering short-term liquidity enhancement of variable-rate bonds. This is something the California State Teachers Retirement System (CalSTRS; AA/A-1+) and the California Public Employees Retirement System (A-1+), among others, have done. However, one key component of our retirement fund ratings is the credit quality of the sponsoring government. When Standard & Poor's downgraded the state of California earlier this year, we also lowered the long-term rating on CalSTRS.

Sidebar: OPEBs Are Affordable For Now

In contrast to their public pension funds, few local governments had trust funds for other postemployment benefits (OPEBs) established at the time of the stock-market downturn. Consequently, they did not experience trust fund losses that will have to be amortized.

Most local governments provide OPEBs on a pay-as-you-go basis (see “Largest U.S. Cities Show Mixed Progress In Meeting Their OPEB Liabilities.” published March 12, 2009). In our opinion, this will create increasing long-term costs that may eventually be more significant than pension costs, although the problem may take longer to manifest itself than that of increased pension contributions. In general, we believe that cities that do have OPEB trust funds have no legal requirement to continue funding at actuarial levels beyond pay-as-you-go. For instance, New York

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City, one of the few cities with OPEB trust funds, is actually reducing its OPEB trust contribution for indirect budget relief.

Related Research

- USPF Criteria: "GO Debt," Oct. 12, 2006
- USPF Criteria: "Public Pension Funds," June 27, 2007

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