Retirement benefit risks loom over many governments’ credit quality
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Full market value funding would insulate pension sponsors from numerous risks

» Reduces reliance on future investment returns to cover current costs
  – Employer normal cost, CalPERS Highway Patrol:
    › 19.1% of payroll @ 7.0% discount rate
    › 40.0% of payroll @ 5.0% discount rate

» Asset-liability matching mitigates interest rate risk
  – Assets and accrued benefits with same duration impacted equivalently by changes in market interest rates

» Prevents higher costs at economically inopportune points in time (i.e., “generational equity”)
  – Mitigates risk that economy / tax base cannot concurrently pay for current government services, bonded debt and legacy employee retirement obligations
Pensions are “must-pay” obligations for most state and local governments

» Pension unaffordability = debt unaffordability
  - Risks are higher than ever for many, but vary significantly

» Most state and local governments have high investment grade ratings

» Service solvency a key credit consideration & proxy for “sustainability”
  - Unfunded liabilities are debt-like obligations, a claim on future resources
  - Bondholder risk rises as pensions + other fixed costs “crowd-out” essential services

» Bond default and/or bankruptcy usually precedes pension benefit defaults
  - Puerto Rico
  - Detroit, MI
  - California cities of Vallejo, Stockton & San Bernardino
  - Harvey, IL
Public pension liabilities and assets at historically elevated levels relative to US economic base

Unfunded liabilities soar when discount rate adjusted: $4.7 trillion reported by Federal Reserve as of year-end 2018

Source: Board of Governors of the Federal Reserve System, “Financial Accounts of the United States”
Government pension contributions are higher than ever, for many

Contributions to Connecticut’s two largest pension systems, % of revenue

Sources: System actuarial valuations and state comprehensive annual financial reports
Benefit outflows to remain near peak levels of economic significance for ~next 20 years

Benefit outflows as % of active employee payroll

Source: Teachers’ Retirement System of Illinois, Public Employees’ Retirement System of Mississippi
Pay-as-you-go can be affordable

…but not always

» City of Portland, OR
  – Closed public safety system funded with dedicated levy

» State of Indiana
  – Largest system by total liability has some assets, but is close to PAYGO
  – Balance sheet burden of unfunded liabilities is essentially at median for state governments

» State of Kentucky
  – Contributions to “non-hazardous” state employees system now very close to PAYGO
  – Higher pension costs have driven one participating employer into bankruptcy

» Commonwealth of Puerto Rico
  – Bond defaults have enabled government services and PAYGO pension benefit payments to continue
Negative cash flow raises importance of investment return path

Near-term recession stands to cause more credit damage than last, due to funding position and heavy benefit outflows

Source: Moody's Investors Service, based on Dallas Police & Fire Pension Fund actuarial valuation
Reach for yield means high expected volatility for US public pension portfolios

Macro-investment risk-return map

Expected volatility required for 7.0% expected returns

Source: Moody's Investors Service, based on JP Morgan 10-year capital markets assumptions
Many governments face limited ability to change benefits for current employees

Diverse answers emerging from state courts on key legal questions concerning pension reforms

» Can benefits be changed prospectively for current employees’ future work?
  – Examples: Yes in Florida, No in Illinois

» Can cost-of-living adjustments be changed prospectively for current employees?
  – Examples: Yes in Oregon, No in New York

» Can cost-of-living adjustments be changed for current retirees?
  – Examples: Yes in New Jersey, No in California
Ohio’s benefit flexibility is significant

COLA suspension reduced STRS’ unfunded liabilities and statutory funding period

Sources: State Teachers Retirement System of Ohio, Moody’s Investors Service
OPEBs a primary “fixed cost” driver for some governments

Hawaii contributing “more and sooner” to retire unfunded OPEB liability and lower long-term OPEB costs (right-hand chart)

Source: Moody’s Investors Service, Hawaii EUTF actuarial valuation
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