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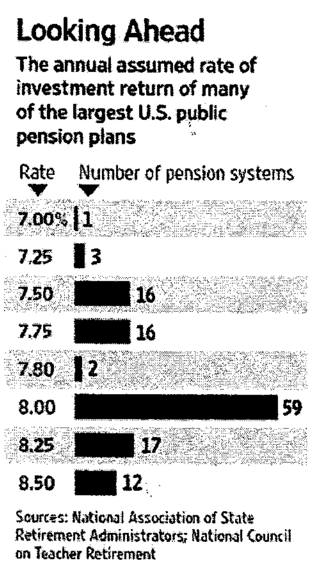
Public Pension-Fund Squeeze

It Is Actuaries vs. Local Governments Over Return Rates; 'We Cannot Afford This'

By JEANNETTE NEUMANN And MICHAEL CORKERY

Some public pension funds are finding themselves caught in a squeeze between actuaries worried about future benefit costs and local governments worried about immediate budgets strains.

The tension was on display last week, when California pension fund Calpers decided to hold its expected annual return rate steady. The fund's actuary had recommended that the California Public Employees' Retirement System adopt a more-conservative long-term investment expectation; nearly a dozen local officials attended a meeting last week to urge Calpers not to change the rate.



Calpers agreed to the status quo, which will help the governments avoid higher-contribution payments near term. But if Calpers over time fails to hit its investment target, it eventually will come up short of its goals—potentially causing a burden that will fall on governments in the future.

The issue highlights a debate that has caught fire in recent months: whether the underfunding at many public pension funds is partly a result of unrealistic investment expectations as well as accounting methods that underestimate the true size of liabilities. Pension funds say their rates are prudent in the long run, pointing to returns that over the past two decades met or exceeded expectations.

In deciding to keep its assumed investment return rate at 7.75%, the board of the $227 billion fund cited hardships that a lower rate would inflict on local governments. Calpers also said it thought the return was achievable.

The fund's decision is drawing criticism from some who contend it was made for the wrong reasons.


Associated Press

"To say that you should adopt an assumed rate of return because you want to keep contributions low is absurd," says Andrew Biggs, a resident scholar at the conservative American Enterprise Institute, who testified before a House panel last week. If Calpers's actuary is right, he says, "it means you will have to pay higher contributions in the future."

Pension funds pay retirement benefits using a combination of investment income and

Dave Lewis
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Calpers President Rob Feckner, left, and Vice President George Diehr last week when the fund decided to hold its annual return rate steady.

contributions from employees and state and local governments. They use their assumed rate of a return as their "discount rate," which they use to calculate the present value of benefits they owe to retirees in the future. The lower the discount rate, the higher a pension fund's liabilities, possibly requiring higher contributions from local governments.

Calpers's chief actuary had recommended lowering the return rate to 7.5%. That would have bumped up what local California governments pay to the state pension fund by 1.5% to about 3% of their payroll in many cases, according to a Calpers spokeswoman.

"We cannot afford this," Larry Lavagnino, the mayor of Santa Maria, wrote in a letter to Calpers, saying a lower rate would cost the small city an additional "$575,000 to $1.9 million annually."

In another letter, Gary Arant, general manager of the Valley Center Water District, said water sales have plummeted in recent years.

Read the Letters to Calpers

Read letters to Calpers advocating that they retain the existing discount rate.

"This, coupled with the economic problems all of California is facing ... has caused us to slash our controllable expenses," Mr. Arant wrote. "Any increase in our costs at this time only increase[s] the pain in our community."

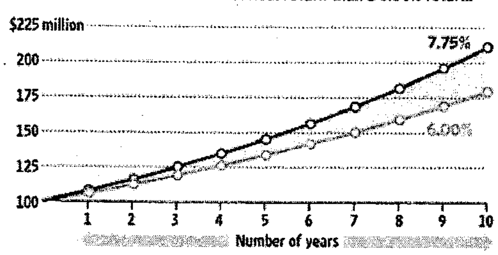
Calpers says it has earned an average annual rate of return of 7.79% over the last 20 years. Looking forward to the next two decades or more, Calpers projects it will earn an average of 7.8%, based on thousands of different investment performance scenarios.

The median expected rate of return among state pension funds is 8%, according to Wilshire Associates, an investment consulting firm. Over the next decade, Wilshire projects public pension plans will see a median annual return of 6.5%.

The Washington state pension fund in 2009 rejected calls from its actuary to lower its rate, in its case to 7.5% from 8%, partly out of concern for the effect on government employers.

Two Tracks

Over 10 years, a pension fund would earn $32 million more on its initial $100 million from a 7.75% annual return than a 6.00% return.



Source: Pew Center on the States

There wasn't a "big push to create more budget pain if you don't have to," said Steve Hill, director of the Washington Department of Retirement Systems. He added that some state investment officials believe the 8% assumed rate of return is achievable and it was within the actuary's recommended range.

The actuary, Matt Smith, says that while he still has to complete his analysis, he expects again this summer to recommend cutting the state's return expectation.

"If you do miss the mark on your assumption, I'd much rather have deferred savings than deferred losses," he says.

Corporations use a more-conservative discount rate for their pension funds, based on interest rates of highly rated corporate bonds yielding about 6%.

Some say that with governments grappling with budget deficits, it is unlikely that pension funds will change their discount-rate methodology unless they have to.

Joshua Rauh, a finance professor at Northwestern University's Kellogg School of Management, has argued that public pensions should use a discount rate based on Treasury yields, which for long term bonds are currently about 4%.

"Unless there is pressure from the federal government or [an accounting standards board] that requires the discount rate to change, it is not going to happen," he says.

Other economists say using a so-called risk-free rate would result in an overfunding of retirement systems because their often stock-heavy investments are likely to earn more than Treasurys.

"In effect, current taxpayers would be paying more so future taxpayers would pay less," said Dean Baker, a liberal economist and co-director of the Center for Economic and Policy Research in Washington, D.C. in testimony last week before a House panel.

Added Calpers Chief Investment Officer Joe Dear in an email: "Running a risk-free portfolio would be an incredibly expensive, gutless investment strategy that left billions on the table for taxpayers to make up."

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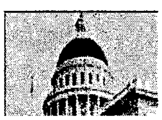

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