McDonnell Investment Management

Growing Unfunded Pension Liabilities:
The Importance of Credit Research for State and Local Government Bonds

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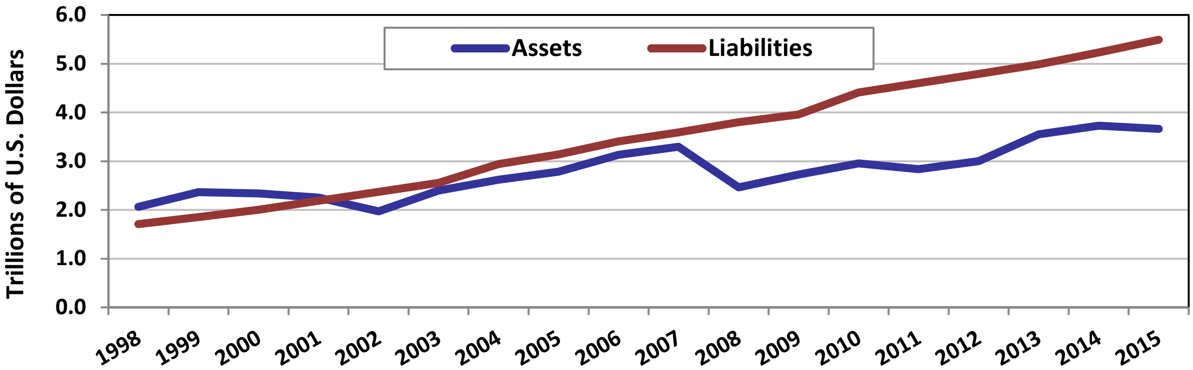
State and local governments offer defined benefit pensions to their public employees. The size of the unfunded portion of the liability associated with future benefit disbursements has been growing for years. Depending on the expected rate of return used, the aggregate state and local government unfunded liability at the end of 2015 was estimated to be anywhere from $1.8 trillion(1) to $3.3 trillion.(2) These growing liabilities have resulted in state and local governments making larger contributions to employee pension and insurance funds which creates immediate difficulties for already tight budgets. The contributions have increased to approximately $210 billion in 2015 from $95 billion in 1998.(3) Even with the increased contributions, the aggregate unfunded pension liabilities have continued to grow.

The graph below depicts the $1.8 trillion difference in assets and liabilities of state and local governments' pension plans at the end of 2015. The aggregate total of outstanding pension liabilities was approximately $5.5 trillion compared to approximately $3.7 trillion in total assets to fund those liabilities.(1)

State and Local Government Pension Assets and Liabilities



Source: Federal Reserve

How Did We Get Here?

- **Timing Issues:** Politicians make retirement promises to current employees with payments on those promises not required until years later. In many cases, the benefits increased to levels that governments could not afford. Defined benefit plans were created with the intention that state and local governments would set aside adequate contributions to provide retirement benefits for employees in the future.
- **Intentional Underfunding:** Budget pressures have led lawmakers in many states to contribute less than the amount necessary to prevent unfunded liabilities from growing.
- **Less Transparent Accounting Rules:** Instead of marking to market, public pension plans were allowed to smooth assets over a moving 5-year average. As a result, following the volatile market downturn experienced in 2008, many pension fund assets and funding ratios were greatly overstated. The recent implementation of GASB 68 has helped improve the transparency and accuracy of pension reporting. Through GASB 68, net pension liabilities are now required to be reported on an entity's balance sheet, not buried in footnotes, and asset-smoothing has been eliminated.
- **Low Interest Rates:** The current low interest rate environment has lowered realistic returns significantly below most plans' assumed rates of return. Pension plans use assumed rates that historically were achievable. In this low interest rate environment, however, those returns are difficult to achieve.
- **Demographic Changes:** Forty-five million baby boomers are expected to retire over the next decade (US Census Bureau), creating a declining ratio of workers to retirees. Adding to that concern are population shifts and people living longer today than they were when these plans were created. Longer lifespans create more years of pension benefit support required for retirees.

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How Are Governments Tackling The Challenges?

- **Migrating to Riskier Assets**: In the current low return environment, many governments have been moving into riskier, less liquid and more complex asset classes such as real estate, hedge funds and private equity investments, to attempt to increase expected returns.
- **Unrealistic Return Expectations:** Governments have been using overly optimistic long-term rates of return which increases the earnings expected to come from investments and therefore reduces the need to add cash.
- **Pension Obligation Bond Issuance:** Some governments have issued Pension Obligation Bonds ("POBs"). POBs are taxable bonds with bond proceeds going toward paying off all or part of the government's unfunded pension liability. POBs are intended to reduce pressure on the government's cash position and offer cost savings if bond proceeds are invested in assets that achieve a rate of return that is higher than the cost of the bond.
- **Opting for Bankruptcy:** Bankruptcy is an option of last resort that can help struggling municipalities restructure their debt, renegotiate contracts and reform their pension systems. This creates a potential conflict between bondholders and pensioners and, in recent cases, settlements have favored pensioners over bondholders.
- **Addressing Pension Reform:** State and local governments may pursue pension reform with the goals of reducing the overall costs of public pensions and reducing the fiscal risks borne by taxpayers; options include moving from defined-benefit to defined-contribution pensions (such as a 401(k)), adjusting the retirement age, reducing the cost-of-living adjustment to current retirees and reducing benefits offered to new employees.

Market Vulnerabilities

- Local Government Bonds that require annual appropriation by the local government to pay debt service.
- Limited Tax Local General Obligation Bonds that are at or near the tax rate limit.
- State and local governments with weak pension funding and pension benefits protected from being diminished or impaired.

Importance of Municipal Credit Research

- Given the significant budget pressures facing state and local governments and the challenges to fund pension obligations, municipal bond credit expertise is critical in order to identify both risks and opportunities.
- As the burdens of unfunded pension obligations increase, the potential for credit rating downgrades and credit spread widening rises.
- The state and local government sectors accounted for approximately 30% of municipal bond issuance in 2015[(4)] and despite all the challenges cited above, opportunities exist in these sectors with in-depth credit analysis.
- We identify opportunities by, among other things, analyzing the size of the pension liabilities; the reasonableness of the assumptions used to measure the pension liabilities; and the ability to fund pension liabilities in relation to current economic and financial trends and expectations.

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