Pension rehab starts with accountability

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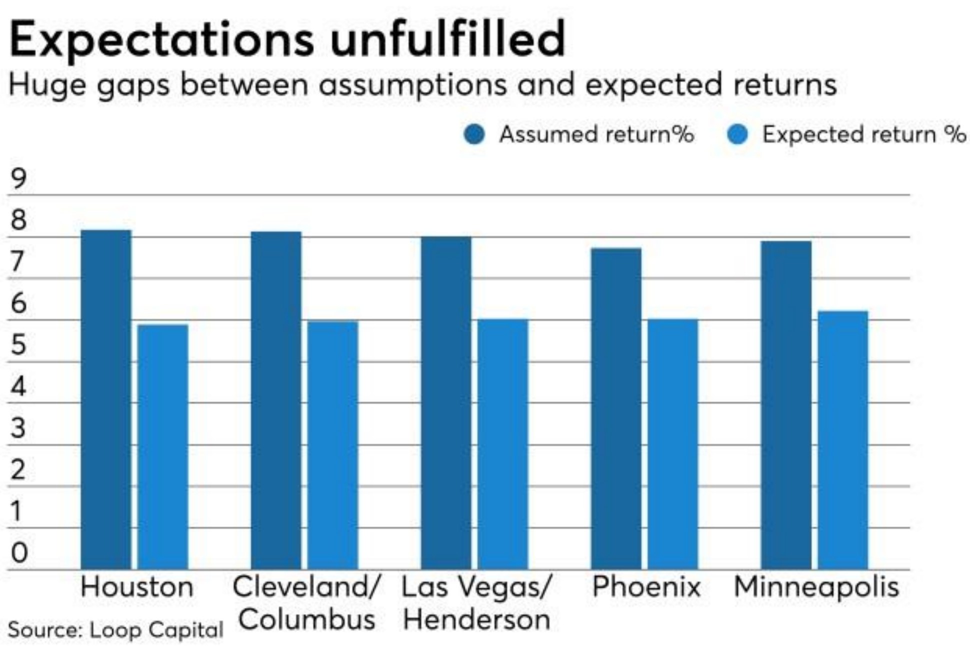
PHOENIX - Public pension managers must be held more accountable, according to a report from Loop Capital, which also concludes that meaningful improvements in retirement plans can be made without federal help.

The report, written by Loop managing director and chief strategist Chris Mier, compares public and private pensions and discusses the complexities for issuers struggling with unfunded pension liabilities and why there is disagreement about the scope of the problem. It then offers a “12 step plan” for reform.



Investors, taxpayer advocates, economists, and others are increasingly concerned about the long-term retirement liabilities of issuers, which have so far taken priority over bondholders in major municipal bankruptcy proceedings such as those in Detroit. But Mier points out that there is no consensus on whether the problem is a full-blown crisis.

“On one extreme, Joshua Rauh, currently of Stanford University, calculates the public pension unfunded price tag for combined state and local pensions at $5 trillion,” Mier writes. “At the other end of the spectrum, the Center for Retirement Research (CRR) has estimated the problem at about $1.5 trillion. Both of these estimations are provided by academics of equivalent timber, yet they differ by more than a substantial amount.”

The difference arises from the assumed discount rate, which is the rate of a return a pension expects to receive on its investments. Rauh calculates the liability using the “risk-free” rate, using the 10-year Treasury note yield of 2.25%. Under Governmental Accounting Standards Board standards that were only recently changed, the investment rate assumption of the pension plan was used, a rate that would be about 7.5% now.

“Those who use Rauh’s risk-free discount rate selection perspective can be expected to arrive at a different conclusion as to the size, the cause, and the solutions relative to those who agree with the CRR,” Mier writes. “Using the risk-free rate boosts the problem to one of a substantially different magnitude than the CRR. In essence, the magnitude is so vastly different, that we cannot likely be talking about the same problem!”

Pensions are complex, Mier’s report asserts, because of factors inherent in their structure such as labor agreements as well as external factors such as political pressures. Furthermore, pension liabilities and the laws under which pensions operate vary widely from state to state.

“Pensions operate under 50 different state constitutional and statutory regimes,” Mier says. “Legally, the rules governing over 4,000 public pensions are a function of each individual state’s constitutional and statutory provisions, which vary from plan to plan. Jurisdictional issues are frequently thorny and can be interpreted differently by legal experts. Control can be confined to the local level or it can be shared.”

“Reformers” who view the pension liability problem more gravely have begun making progress. Some of the nation’s pension funds, such as the California Public Employees' Retirement System have recently dropped their discount rates, though not nearly as low as the risk-free rate. And some governments have had success negotiating new pension deals that are more long-term sustainable, such as Arizona's passage last week of legislation overhauling the underfunded Arizona's Corrections Officers Retirement Plan.

Mier's report offers its own "12 step" plan, which posits that the federal government does not need to get involved to get the pension problem under control. Some pundits have suggested that federal action could help save state and local pensions. Finance writer Josh Barro, for example, has suggested that Congress could mandate some additional retirement savings that would ease pressure on localities to do this.

Among the suggestions in the Loop report is a greater emphasis on personal liability for those entrusted with pension funds. Plans should "require pension administrators and trustees to have demonstrable qualifications in pension and investment management," and "should place a legal standard of personal liability upon senior administrators and trustees, as is standard in asset management, brokerage, investment banking and investment research activities," wrote Mier.

"Achieving lasting solutions to the difficult problems many pensions face will require an accurate appraisal of what the problems are as well as non-ideological quantification of their size," Mier concludes. "We can make significant improvements in pension systems nationwide that address the concerns of retirees for fair treatment and also represent the interests of taxpayers."