Pretend Pensions

Just How Much Are California's Public Employee Retirement Funds Underwater?

And Where Does Marin Fall?

Joe Nation, Ph.D.
Professor of Public Policy
Stanford University
Sept. 22, 2010

Stanford's Public Policy Program And Practicum

- Practicum combines with International Policy Studies (IPS)
  - Students are MPP, MBA, JD, IPS, or Ph.D. candidates
- Projects (and clients) include:
  - Human Trafficking In India (Asia Foundation)
  - Prosecutorial Discretion in the Filing of Criminal Charges (National Center on State Courts)
  - U.S. Counterinsurgency Strategy in Afghanistan (U.S. Army)
  - The Distributional Effects of a Carbon Tax (Carnegie Foundation)
  - Predicting Judicial Performance (Commission on Judicial Performance)
  - Developing a Sovereign Fiscal Responsibility Index (Peterson Foundation)

Outline

- Quantifying the shortfall
- Research methodology
- How we got here
- Where does Marin fall?
- What’s next?

California's State Public Employee Pensions Are Underfunded By $500 Billion

- Published by SIEPR in April 2010
- Research conducted by five former students
  - Now employed at Goldman Sachs, Bain Capital, a local start-up, and a small local investment bank
- John Shoven (SIEPR Director) and I served as Faculty Advisors
- Completed for Governor's Office
- Snapshot of CalPERS, CalSTRS, and UCRS
- Shortfall equivalent to about 6 state budgets

How We Got To Half A Trillion

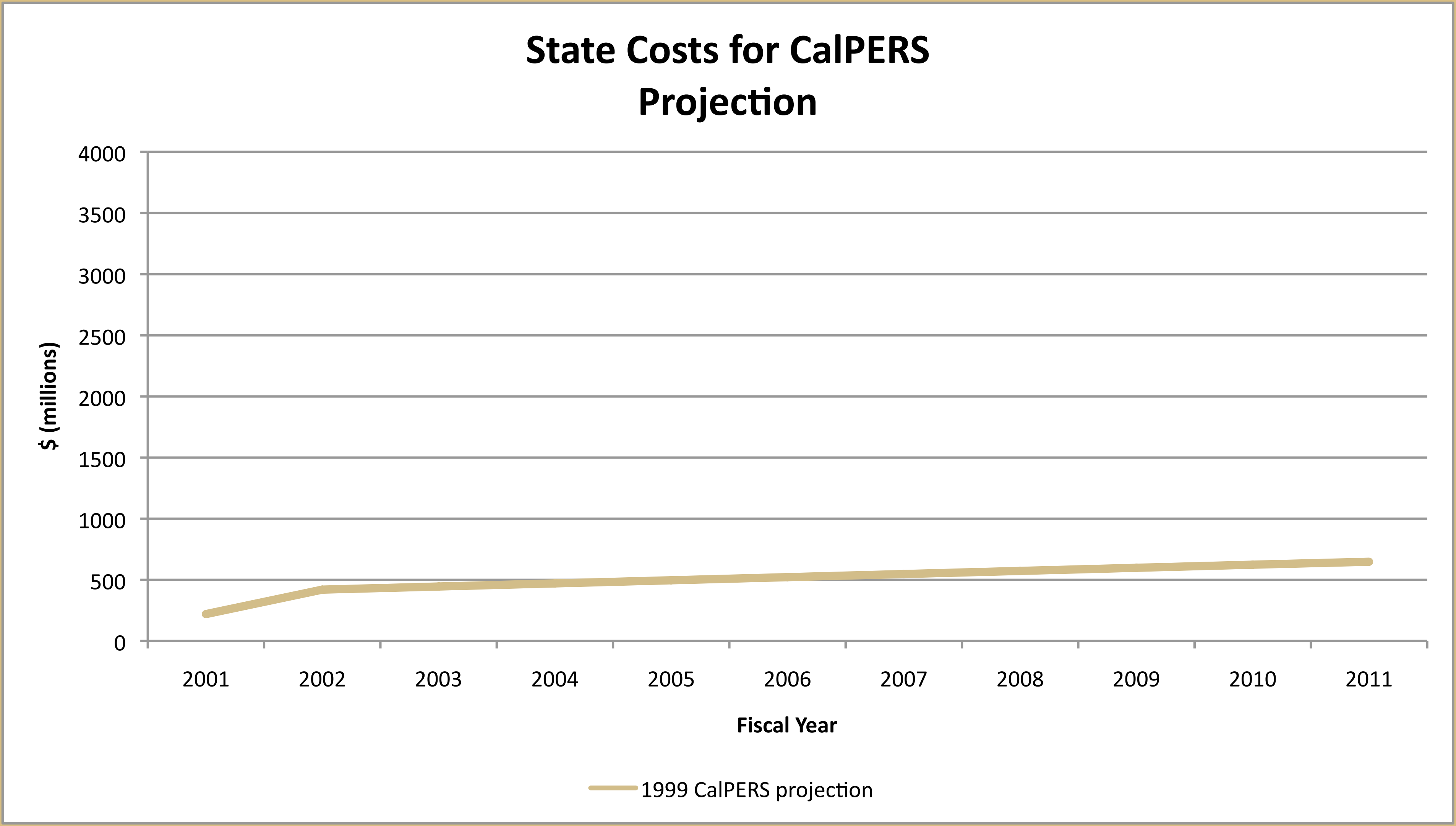
	Reported, 2008				Stanford Estimate			
	Discount rate	**Liabilities (AAL)**	**Unfunded liabilities (UAAL)**	**Funding ratio**	**Discount rate**	**Liabilities (AAL)**	**Unfunded liabilities (UAAL)**	**Funding ratio**
CalPERS	7.75%	$277,246	$38,679	86.0%	4.14%	$478,256	$239,689	49.9%
CalSTRS	8%	$177,734	$16,236	90.8%	4.14%	$318,177	$156,679	50.7%
UCRS	7.50%	$42,576	$553	98.7%	4.14%	$70,765	$28,742	59.3%
Total		497,556	***$55,468***			867,198	$425,110	

Including 2008-2009 losses ($109.8 billion), estimated shortfall about $525 billion

But Aren't These Unrealistic Estimates?

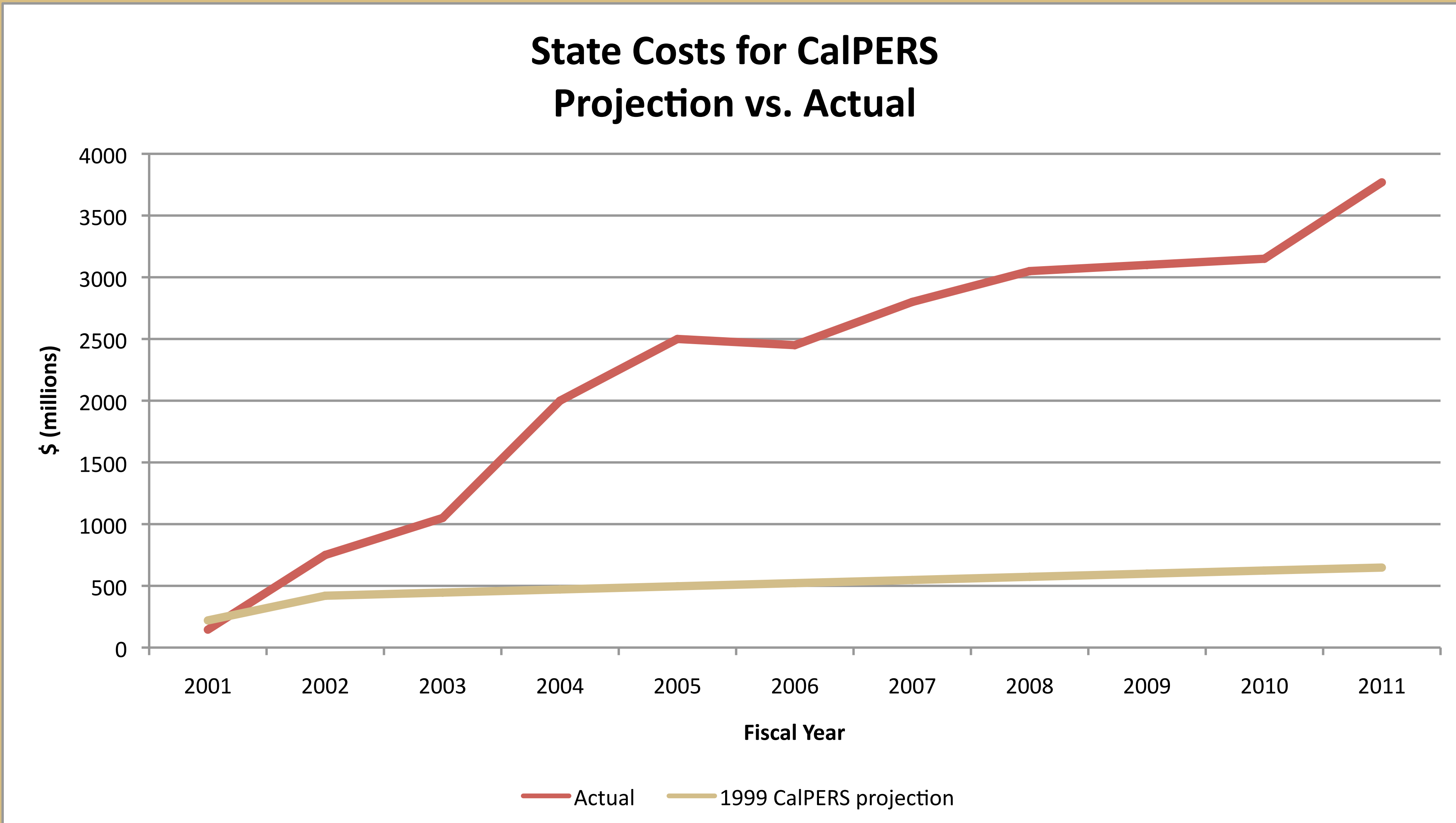
- Northwestern University recently estimated a $475 billion shortfall for California; $4-5 trillion for U.S.
  - Pew Center estimated $1 trillion for U.S.
- Funds themselves now acknowledge larger shortfalls
  - CalPERS asking for bigger General Fund contributions
  - CalSTRS seeking $4 billion per year based on recent actuarial report
  - UCRS now estimates $28 billion retirement and OPEB shortfall
    - Among solutions: employees contribute 4-10%, up from 2-5%

CalPERS Understated Budget Requests



Source: Office of Governor Schwarzenegger (http://gov.ca.gov/press-release/15551), retrieved Sept. 9, 2010

CalPERS Understated Budget Requests



Source: Office of Governor Schwarzenegger (http://gov.ca.gov/press-release/15551), retrieved Sept. 9, 2010
Note: 2010-11 are estimates.

Pension Fund Health Depends In Part On How We Value Future Liabilities

- We use discount rates to assign a present value (PV) to future payments
- What is the value today of a stream of future payments?
  - Similar to a Lottery winner
  - Do I take the $200,000/year for life or a lump sum of $3 million?

How We Value Future Liabilities Depends On Discount Rates

- A $1 billion obligation spread over 18 years at 4% = PV $494 million
- The same $1 billion obligation at 8% = PV $250 million
- GASB requires agencies to match discount rates and expected rates of return
  - So CalPERS, others discount at 7.5%-8.0%
- Strong argument to discount at a risk-free rate, or at the TIPS rate, currently 2%

GASB's Rules Don't Make Financial Sense For Defined Benefit Plans

- Most public employees retire with legally, contractually guaranteed income
- Case law is clear
- So fund liabilities are related to required payments to retirees, not investments or rates of return
  - E.g., if the fund's rate of return doubles, does the obligation to the retiree change?
  - How would you plan for a personal obligation that you *must* pay in 10 years?

Others Argue For “Risk-Free” Discount Rates

- Professors Joshua Rau (Northwestern) and Robert Novy-Marx (University of Chicago)
- Alicia Munnell, (Boston College, Pres. Clinton Council of Economic Advisors)
- Donald Kohn (Vice Chair, Federal Reserve)
  - "Public pension benefits are essentially bulletproof promises to pay. The only appropriate way to calculate the present value of a very-low-risk liability is to use a very-low-risk discount rate....... [Any other method] pushes the burden of financing today's pension benefits onto future taxpayers, who will be called upon to fund the true cost of existing pension promises."

Let's Assume A Discount Rate of 6% (Using 2008 Fund Data)

	Fund	Liabilities (AAL)	Actuarial Value of Assets (AVA)	Unfunded liabilities (UAAL)	Funding ratio
CalPERS	CalPERS	$360,286	238,567	-121,719	66.2%
CalSTRS	CalSTRS	$239,694	161,498	-78,196	67.4%
UCRS	UCRS	$53,310	42,023	-11,287	78.8%
Total	Total	$653,290	442,088	-$211,202	67.7%

This Financial Disaster Accelerated In 1999 With SB 400

- Public employee unions learned to work both sides of the aisle
  - Prison guards, police/law enforcement, firefighters
- SB 400 expanded benefits
  - CalPERS pledged "no increase over current employer contributions is needed for these benefit improvements"
  - SB 400 passed with only 7 of 120 "no" votes
- Many now earn more in retirement than when active
  - A public safety employee *without spiking* can earn 60% more (in nominal dollars) in retirement than while on active duty

The Funds Failed Retirees And Taxpayers

- When funding ratios dropped, funds failed to contribute sufficiently
  - UCRS is just ending a nearly 20 year "contribution holiday"
- Funds bet on the market--and lost
  - CalPERS requires market to double every 9 years
  - Bet on 25,000 Dow Jones by 2009; down 5.1% since Oct. 1, 2000
- Funds are far from transparent
  - CalPERS ignored our requests for information, even Public Records Act requests
  - CalPERS failed to disclose the possible downside of increased benefits with SB 400
- And BTW, political leaders failed miserably, as well

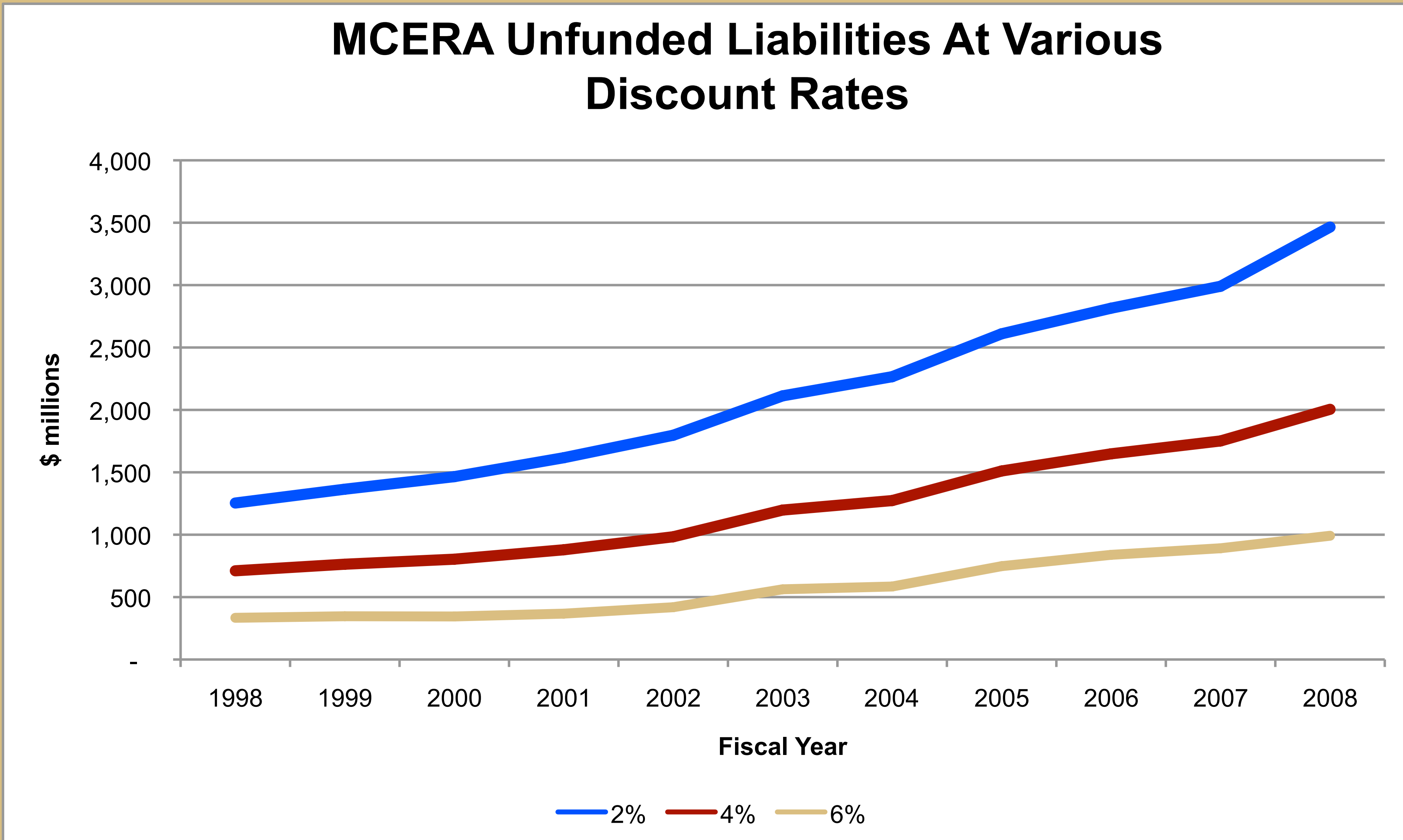
CalPERS, CalSTRS Have Criticized the Stanford Study

- Old data
  - CalPERS rejected our request(s)
  - New data suggests problem even worse
- Argue that not even Stanford uses a risk-free discount rate
  - And for good reason......we don't guarantee pensions
- Governor's office paid for study
  - Work done free of charge

Thank Goodness We Have Our Own Fund Here In Marin

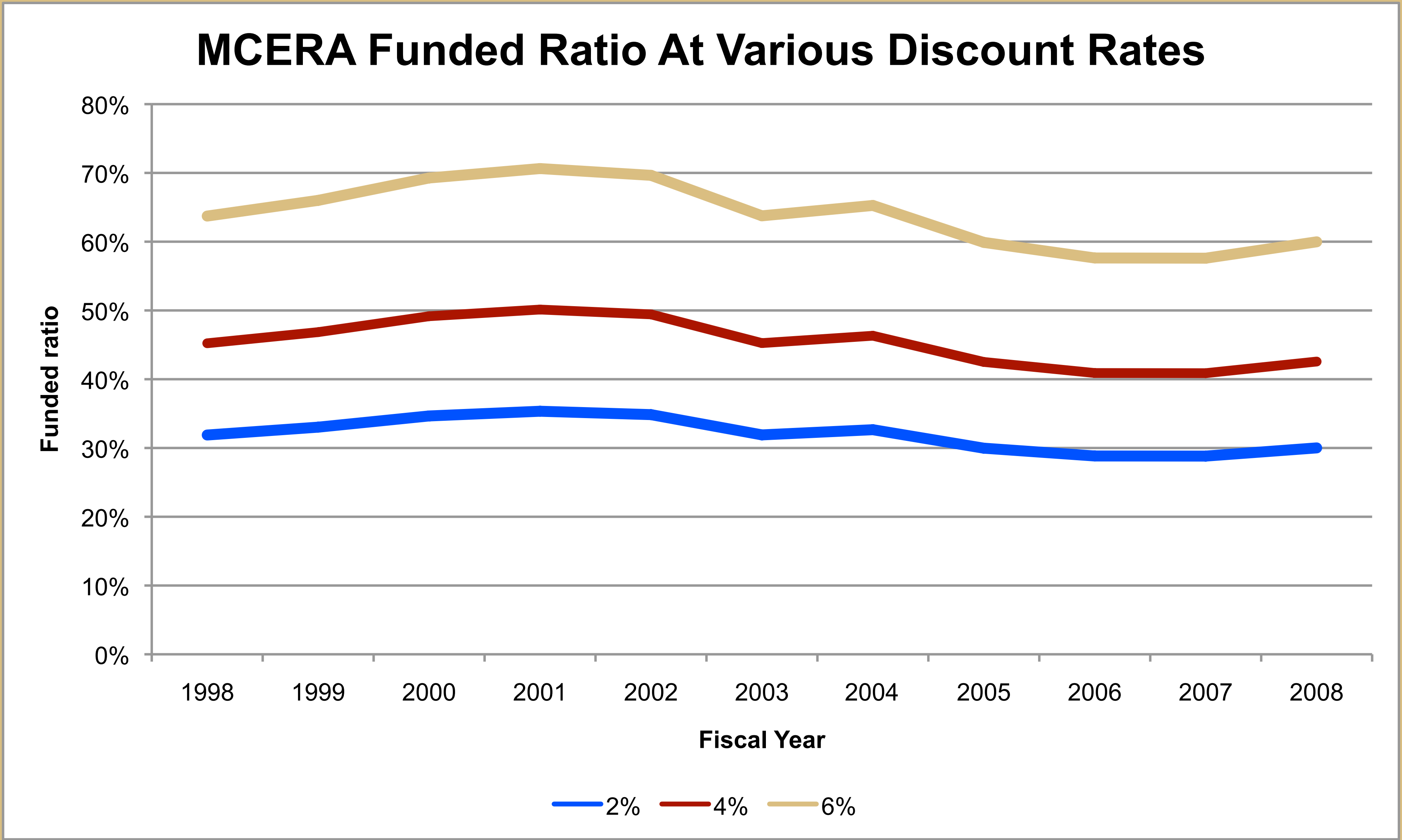
- Most Marin cities, special districts are CalPERS members
- But MCERA (the County, San Rafael, and the Novato Fire Protection District) operates independently
  - There are 22 1937 Act counties in California that also have separate pension funds

But MCERA Unfunded Liabilities Range From $1-$3.5 Billion



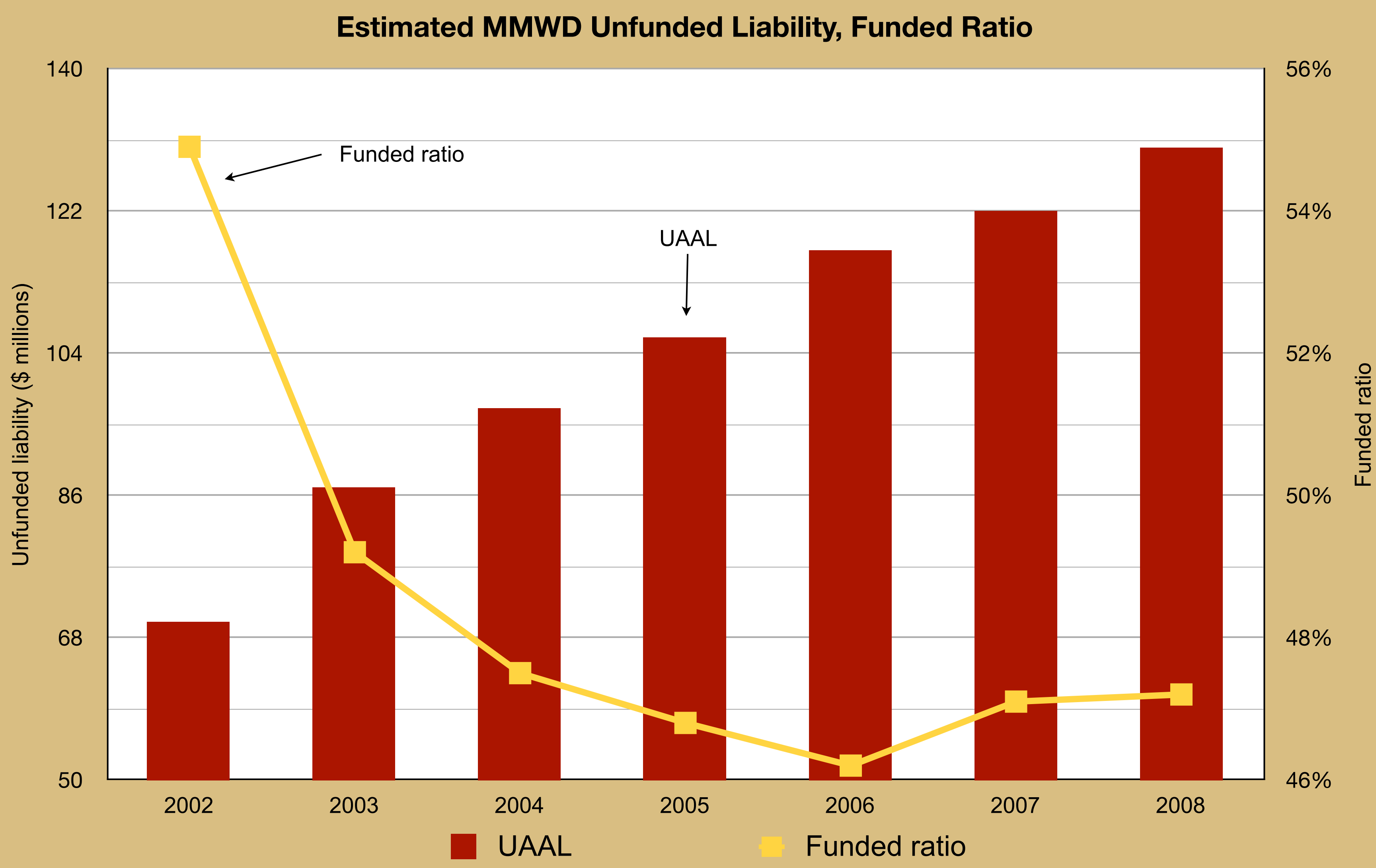
Source: State Controller, Public Retirement Systems Annual Report; MCERA reported data.

MCERA Funding Ratio Is At Most 60%

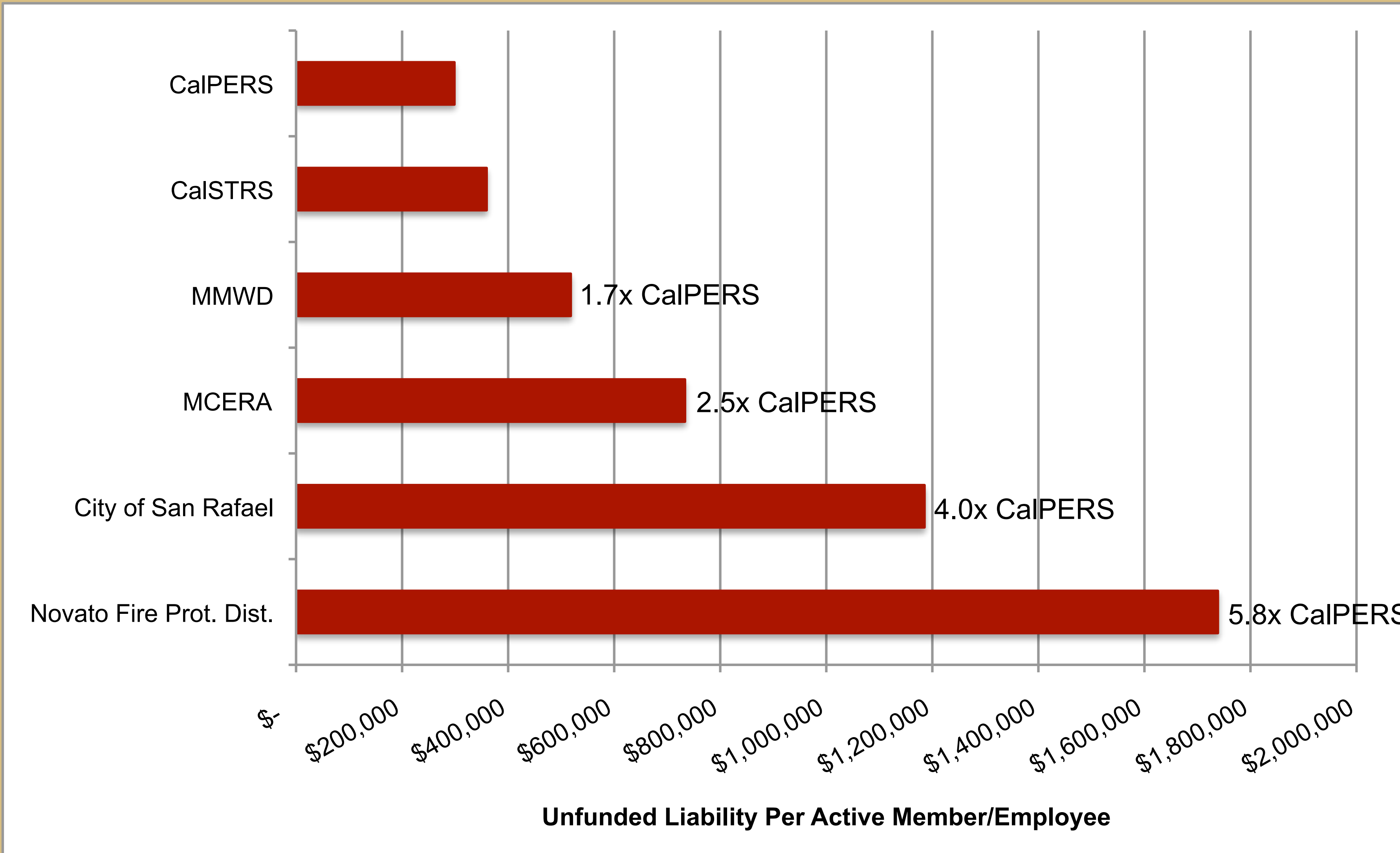


Source: State Controller, Public Retirement Systems Annual Report; MCERA reported data.

MMWD Funded Ratio About 47% In 2008; Likely Down To About 44% Today



Marin Funds Are In Relatively Poor Condition



Sources: CalPERS, CalSTRS, MMWD, MCERA Annual Financial Reports
Active MCERA, San Rafael, Novato Fire Protection District member/employee counts based on phone interviews, email correspondence.

How To Dig Out

- Acknowledge the problem
  - Beneficiaries, public employee unions continue to seek increases
- Involve the community, stakeholders
- Recognize that minor fixes will *not* work
  - E.g., 5th tier won't matter (in short- to medium-term) if you're not hiring
  - Employees will have to contribute more
  - Avoid contribution "holidays"
  - Plan for the long term
  - Avoid issuing debt
  - Don't "spread" asset losses over long period