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Pension Bomb Ticks Louder

California's public funds are assuming unlikely rates of return.

The time-bomb that is public-pension obligations keeps ticking louder and louder. Eventually someone will have to notice.

This month, Stanford's Institute for Economic Policy Research released a study suggesting a more than $500 billion unfunded liability for California's three biggest pension funds—Calpers, Calstrs and the University of California Retirement System. The shortfall is about six times the size of this year's California state budget and seven times more than the outstanding voter-approved general obligations bonds.

The pension funds responsible for the time bombs denounced the report. Calstrs CEO Jack Ehnes declared at a board meeting that "most people would give [this study] a letter grade of 'F' for quality" but "since it bears the brand of Stanford, it clearly ripples out there quite a bit." He called its assumptions "faulty," its research "shoddy" and its conclusions "political." Calpers chief Joseph Dear wrote in the San Francisco Chronicle that the study is "fundamentally flawed" because it "uses a controversial method that is out of step with governmental accounting standards."

Those standards bear some scrutiny.

The Stanford study uses what's called a "risk-free" 4.14% discount rate, which is tied to 10-year Treasury bonds. The Financial Accounting Standards Board requires *corporate* pensions to use a risk-free rate, but the Government Accounting Standards Board allows *public* pension funds to discount pension liabilities at their expected rate of return, which the pension funds determine. Calstrs assumes a rate of return of 8%, Calpers 7.75% and the UC fund 7.5%. But the CEO of the global investment management firm BlackRock Inc., Laurence Fink, says Calpers would be lucky to earn 6% on its portfolio. A 5% return is more realistic.

Last year it was proposed at a GASB meeting that the public pensions play by the same rules as corporate pensions. But unions for the public employees balked because the changed standard would likely require employees and employers to contribute more to the pensions, especially in times when interest rates are low. For now, it appears the public employee unions will prevail with the status quo accounting method.

Using these higher return rates for their pension portfolios, the pension giants calculate a much smaller, but still significant, $55 billion shortfall. Discounting liabilities at these higher rates, however, ignores the probability that actual returns will fall below expected levels and allows pension funds to paper over the magnitude of their problem.

Instead, the Stanford researchers choose to use a risk-free rate to calculate the unfunded liability because financial economics says that the risk of the investment portfolio should match the risk of pension liabilities. But public pensions carry no liability. They're riskless. That's because public employees will receive their defined benefit pensions regardless of the market's performance or the funds' investment returns. Under California law, public pensions are a vested, contractual right. What this means is that taxpayers are on the hook if the economy falters or the pension portfolios don't perform as well as expected.

As David Crane, California Governor Arnold Schwarzenegger's adviser notes, this year's unfunded pension liability is next year's budget cut—or tax hike. This year $5.5 billion was diverted from other programs such as higher education and parks to cover the shortfall in California's retiree pension and health-care benefits. The Governor's office projects that, absent reform, this figure will balloon to over $15 billion in the next 10 years.

What to do? The Stanford study suggests that at the least the state needs to contribute to pensions at a steadier rate and not shortchange the funds when markets are booming. It also recommends shifting investments to more fixed-income assets to reduce risks.

But what the public-pension giants find "political" and "controversial" is the study's recommendation to move away from a defined benefits system to a 401(k)-style system for new hires. Public employee unions oppose this because defined benefits plans are usually more lavish, and someone else is on the hook to make up shortfalls. Calpers and Calstrs are decrying the Stanford study because it has revealed exactly who is on the hook for all of this unfunded obligation—California's taxpayers.