Trillion-Dollar Pension Crisis Looms Large Over America
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The country's pension system faces trillions of dollars in unfunded liabilities.
Assuming they can laugh about such things, pension fund accountants might consider telling a joke that goes like this:

What's the difference between General Motors and California?

California hasn't gone bankrupt. At least, not yet.

General Motors Corp. did go bankrupt, of course, in a historic Chapter 11 filing orchestrated by the federal government last June. A similar fate for California isn't out of the question, though it is unlikely. No U.S. state has ever gone bankrupt, although California's Orange County back in 1994 and, more recently, the City of Vallejo did take the plunge.

California's $20 billion financial crisis — just the latest in a series, like a Hollywood horror movie with endless sequels — makes it Exhibit A of the pension funding predicaments looming over many state and local governments in the U.S. And as it happens, these crises have a lot in common with the pension overhang that helped sink General Motors last year.

See related article, *Eight Ways To Avoid A Crash*

Over several decades the leaders of both GM and GS (that is, the Golden State) caved in to the demands of aggressive unions, choosing what seemed the path of least resistance. Both gave their employees richer and richer retirement plans during their respective boom years and assumed that their revenue growth and the hefty returns on their pension fund investments would go on forever. Not so long ago, in fact, officials of both GM and California boasted that their employee pension plans were in good shape.

"Our U.S. hourly and salaried pension plans were overfunded by more than 20 percent at year-end 2007," GM's then-CEO Rick Wagoner wrote rosily to shareholders in that year's annual report, "and we do not expect to be required to make any cash contributions to these plans for the foreseeable future."

Those words were written, ironically, in the spring of 2008, when General Motors was on the very eve of destruction. The company was burdened with a huge debt load, a big chunk of which was incurred to fund the pension plan (more on that below).

See related article, *Delphi Liabilty Portends Crisis in Municipal Pensions*

When the economic crisis struck and car sales collapsed that fall, GM's cash reserves evaporated, even as repeated rounds of layoffs left the company saddled with ten retirees for every active employee. The company required a massive federal bailout and bankruptcy to stay in business. Only thanks to cash from the feds did GM's retirees keep their pensions intact. Retirees of GM's then-bankrupt auto-parts subsidiary, Delphi Corp., also kept their benefits.

In the Golden State, meanwhile, the California Public Employees' Retirement System, or CalPERS, had sharply increased benefits for state retirees in 1999. "CalPERS's investment returns provide this historic opportunity," then-board president William Crist declared, "without causing any additional taxpayer burden."

Since then the state's public employee pension outlays have ballooned by 2,000 percent, while state revenues have increased only 24 percent. In the current fiscal year alone, some $3 billion has been diverted from other state programs to pay pensions. And California's general obligation bond ratings from all three agencies — Fitch Ratings, Moody's Investors Service and Standard & Poor's — are the lowest among the country's ten most populous states.

The parallels between GM and California aren't exact. The most notable difference is that states, unlike companies, can't go out of business. Still, there are plenty of similarities to suggest GM was the proverbial canary in the coal mine for California and other cash-strapped states whose pension crises may already have arrived.

"Public pensions can be viewed as a liability eating away at a state's financial strength," says Andrew Horrocks, an investment banker at Moelis & Co. who advised the Canadian government on GM's bankruptcy last year. "This is all about promises made that can't be kept without bleeding taxpayers. It's a striking analogue to GM, and it's frightening."

Just how frightening, however, is a matter for intense debate. Other experts note that whatever problems states have now, public pension funding has improved markedly over the past few decades. "Thirty years ago state pension plans were funded haphazardly; it was the Wild West," says Alicia Munnell, director of the Center for Retirement Research at Boston College. Since then most states have tightened funding requirements, and "things are much, much better now," she adds. "Trends like this count."

Underlying these divergent views are different calculations of the size of the public employee pension problem that get into the arcane world of pension accounting. Don't cringe. The operative concepts — discount rate, projected rate of return and "smoothing" — are pretty simple.

The discount rate helps calculate the amount a company must set aside now to pay future pensions, allowing for the time value of money. The projected rate of return is just what it sounds like — the assumed investment returns on a pension plan's assets.

Smoothing, in turn, is the exercise of leveling out a portfolio's actual performance over two to five years. It evens out one-year aberrations such as the 2008 stock market crash that produced major losses in pension portfolios.

Private companies can exercise discretion in projecting their investment returns but have stricter limits than public funds in setting their discount rate. With a high discount rate and optimistic projected returns — say, 8 percent or more annually on pension portfolios — the public pension landscape doesn't look so bad. By some estimates, the nationwide funding shortfall is "only" $500 billion.

The actual funding gap is at least $1 trillion, the respected Pew Center on the States recently concluded, adding that its estimate likely is low. But using more-conservative accounting assumptions — that is, requiring public pensions to use accounting standards close to those of private plans — produces a markedly different result.

The "politically unspeakable reality" is that the pension systems are underfunded by something more than $2 trillion, says Orin Kramer, chairman of the New Jersey State Investment Council, citing independent research that he recently commissioned. Kramer, whose council oversees a $67 billion state pension system, says politicians have deferred action for too long. "Kicking the can down the road is not sustainable," he says. "The road does not have unlimited duration."

And this $2 trillion shortfall doesn't count something called OPEB, for "other postemployment benefits," mainly health care for retired employees. State and local governments have underfunded those obligations by at least $530 billion, Congress's Government Accountability Office reported last November. The agency also conceded that its number was an extremely conservative estimate. Other forecasts range up to $1 trillion, which would put states' total retirement funding shortfall at a breathtaking $3 trillion.

So what's the right number: $3 trillion or $500 billion? Well, using a lower number conveniently allows politicians and public officials to avoid all sorts of painful moves, such as raising taxes or cutting state spending to pay for pensions. Put another way, it's tempting to engage in "fudging" instead of "smoothing."

But in the end, there is no avoiding economic reality. In its last annual report before filling for bankruptcy, General Motors used an assumed rate of return of 8.5 percent for its U.S. pension fund, even though the Standard & Poor's 500 index fell 38.5 percent that year and GM sustained losses of $11.4 billion on its U.S. pension assets alone. Credit Suisse accounting analyst David Zion has long argued that corporate funds should use their actual rates of return to measure their pension obligations. Public plans, which engage in the same kind of magical thinking as their corporate peers when it comes to pension accounting, could also benefit from following Zion's advice.

Back in 1997, long before Kramer was involved in New Jersey's pension fund, Governor Christine Todd Whitman sold $2.75 billion in pension obligation bonds. After the bond sale New Jersey all but stopped making contributions to its pension plans for more than six years, making it easier to balance the state's budget.

When the moves were criticized as reckless financial engineering, Whitman offered a feisty defense. "You'd be crazy not to have done this," she told Bloomberg News at the time. "It's not a gimmick. This is an ongoing benefit to taxpayers."
In fact, the actions have become a drag on New Jersey's taxpayers. The state now pays on average 7.64 percent annual interest on the 1997 pension obligation bonds, but the fund has earned less than 5 percent a year, on average, since the bonds were issued.

From a funding status of 111 percent back in 2000, the state's pension funds fell below 73 percent for the fiscal year that ended June 30, 2009. The state's current pension-and-benefits shortfall now stands at a whopping $90 billion.

New Jersey's pension problem was part and parcel of the budget mess that sank the reelection bid of governor Jon Corzine last year; his successor, Chris Christie, recently cited a "state of financial crisis" to impose a broad freeze on spending. The state's experience with pension obligation bonds provides another unsettling public sector parallel with the fate of General Motors.

Back in 2003, GM announced a $13 billion corporate bond offering, one of the largest such debt offerings in history, with the proceeds earmarked for its pension plans. "We mortgaged, to some degree, our business," was how Frederick (Fritz) Henderson, then the company's chief financial officer (and last year briefly its CEO), later explained it to analysts. Investor interest was so strong worldwide, thanks to the bonds' hefty yield of 7.22 percent, that GM actually sold more than $14 billion in bonds, along with several billion dollars of convertible stock.

The company threw in some additional cash from the sale of assets, and voilà! — its pension fund deficit was erased overnight. GM said it wouldn't need to make annual cash contributions to its pension plans for years, boosting its earnings. "GM Bond Offer Could Be a Template for Covering Underfunded Pensions," declared a complimentary headline in the Wall Street Journal.

Instead, it was a template for ducking the real issue, because GM was merely substituting one kind of debt for another. "It appears they will achieve a nearly fully funded [pension] status, but they did it by issuing $14 billion of debt," credit analyst Chris Struve of Fitch Ratings said at the time. "So there is a $14 billion debt reckoning in the future."

The reckoning occurred last June, when General Motors walked into federal bankruptcy court carrying a crushing burden of $54 billion of "funded debt," meaning borrowed money. The pension bonds sold in 2003 accounted for more than one fourth of the total. The massive bond sale had solved the company's pension crisis, all right, but at a cost that evokes another, more familiar joke: The operation was a success, but

the patient died.

It wasn't funny to the investors that held those bonds and to those that owned GM stock when the company declared bankruptcy last year. The 2003 bonds were all unsecured, so the bondholders were pummeled along with the company's stockholders.

GM retirees, in contrast, kept their full pensions thanks to $50 billion-plus in federal aid. Thus a historic transfer of wealth from GM's owners and creditors to the company's employees and retirees was made.

New Jersey's Kramer sees a similar scenario for the public sector: an "invisible wealth transfer," as he puts it, from future taxpayers to pension-holding public employees.

The 1966 bankruptcy of Studebaker Corp., a much smaller car company than General Motors, was a watershed in the history of pension plans. Nearly 7,000 Studebaker workers saw their pensions largely or entirely wiped out. The company's collapse eventually spawned the Employee Retirement Income Security Act of 1974, also known as ERISA, which established new funding requirements for corporate defined benefit plans.

ERISA also set up the Pension Benefit Guaranty Corp., funded by insurance premiums from employers, to guarantee pension payments to workers whose companies went bankrupt. Funding of private pension plans began to improve.
But another, less positive development also was occurring. Many private companies began sweetening pension benefits and liberalizing their retirement rules, with GM leading the way.

In 1970, after a 67-day strike by the United Auto Workers union, GM allowed employees to retire after 30 years on the job with full pensions and health care benefits for life. At first, a minimum age of 58 was required to qualify for "30 and out," but soon the minimum age was abolished.

Thus workers could start on the assembly line at age 18, retire at 48 and — if they lived until age 79 — collect pension and medical benefits for more years in retirement than they actually worked. By 1975, GM's pension costs had jumped to 83 cents an hour from 43 cents just three years earlier, writes Roger Lowenstein in While America Aged, his prescient 2008 book about the nation's pension crisis.

In 1976, UAW leaders were "flabbergasted" that 29 percent of the GM workers who retired were under 55, wrote union vice president Irving Bluestone. "We were aware . . . that the trend to early retirement was escalating," Bluestone stated in an internal union memo in April 1977. "But we were surprised at the [extent of the] escalation in 1976. It is astounding."

Such sentiments, however, were kept private. Expressing public doubts about "30 and out" would have been career suicide for union leaders, who stand for reelection every few years. Having served up the gravy train, the UAW's leadership was powerless to hop off.

GM, Ford Motor Co. and Chrysler Corp. executives figured the costs of "30 and out" simply could be passed through to consumers, who didn't have much choice except to buy Detroit cars. But that was about to change. The Japanese threat was looming on the horizon.

Meanwhile, ERISA was producing a sea change in corporate pension plans. By adding to the costs of defined benefit pensions, the law sparked a shift toward 401(k) plans, which have defined employer contributions but no fixed benefit payments.

After ERISA the move away from corporate fixed pensions became a rout. "Virtually no new defined benefit plans have been created in the last ten years," wrote economist William Conerly in a 2005 study for the National Center for Policy Analysis, a conservative think tank. "Once the Cadillacs of retirement plans, they are now the Edsels of employee benefits."

The companies that made Cadillacs (and before that Edsels) stuck with traditional defined benefit pension plans, largely because the UAW insisted on keeping them. The one exception, for a while, was GM's Saturn subsidiary. In 1985, Saturn and the UAW agreed upon a defined contribution plan as part of a push for cooperation in company-union relations.

But the militants who took power at UAW headquarters in the mid-1990s succeeded in scrapping Saturn's 401(k) plan and returning to a defined benefit pension. Today, Saturn is about to disappear. GM dumped the money-losing brand in last year's bankruptcy, and an effort to find a buyer collapsed.

State pension plans stayed with defined benefits for some of the same reasons — the surging power of public employee unions, a trend that began in the late 1960s and '70s. Among the most powerful public unions are the teachers' unions, the Service Employees International Union and the American Federation of State, County and Municipal Employees.

But they aren't the only ones. With the ranks of auto workers dwindling, the UAW has aggressively organized thousands of public sector workers, including those in Detroit's public library system. Last year, for the first time, the number of public employee unionists in the U.S. exceeded the ranks of union members in the private sector. (Ironically, even the investment professionals who manage the assets of New Jersey's state pension system are represented, by the Communications Workers of America. Only the agency's supervisory personnel remain nonunion.)

State and municipal officials — like the Big Three automakers — began systematically sweetening the retirement benefits for their employees. New Jersey boosted pension benefits by 9 percent in 2001 and continued to reduce required pension contributions from state employees. The state's teachers, for example, saw their contributions temporarily reduced to 3 percent of their salaries to fund pensions, down from 8.5 percent.

One 49-year-old state retiree paid a total of $124,000 toward his pension and health benefits during his career, Governor Christie recently told the state legislature, but the state now owes him $3.3 million in pension payments and an additional $500,000 in retiree health benefits. A retired teacher, the governor added, will collect $1.4 million of pension payments even though she paid just $62,000 toward her pension while she was working.

"We cannot in good conscience fund a system that is out of control, bankrupting our state and its people and making promises it cannot meet in the long term," Christie told the legislature in announcing his intention to pursue pension reform.

Public pensions also have played a critical role in spawning California's financial crisis. In the late '90s, CalPERS was comfortably overfunded thanks to a booming stock market and the pension system's annual investment returns as high as 20 percent. So the state, like GM before it, started allowing early retirements for its employees under increasingly generous terms.

Public safety employees led the way. Nobody wanted 60-year-old firefighters trying to scale ladders to save toddlers from burning buildings. But California, again like GM, went too far.

Before 1999, police, firefighters and prison guards could retire at age 50 with 2 percent of their pay for each year worked, with their pensions capped at 60 percent of their salaries. But in 1999 their benefits were sweetened to 3 percent of pay for each year worked, and the cap was raised to 90 percent of their working salaries.

The slogan used by the state's police and firefighters' unions was "3 percent at 50." It bore a striking resemblance to the "30 and out" rallying cry of the UAW in the 1970s.

Meanwhile, California's nonsafety personnel, such as teachers, got retirement sweeteners of their own. The state stopped averaging salaries over employees' final three working years to compute their pensions. Instead, it started using just their final year's pay, which was almost always higher.

It all seemed okay until the state's economy tanked, even more than the rest of the country's. CalPERS's investment portfolio plunged 23.4 percent in fiscal year 2009, leaving the plan at an estimated 65 percent of funding. The pension shortfall is part of a bleak financial picture that, the state's treasurer reported last December, has put the credit spreads on California bonds higher than those of Mexico, Indonesia and the Philippines.

Connecticut stands as another prime example of the damage caused by the unholy combination of optimistic investment assumptions and liberal retirement provisions. The Connecticut Teachers Retirement Fund uses an 8.5 percent projected rate of return. But in fiscal year 2008, the fund's investment portfolio lost 4.77 percent; in 2009 it dropped 17.14 percent.

Generous smoothing wouldn't help the picture much — Connecticut uses a five-year smoothing formula to measure its returns. But even over ten years, the state teachers pension fund's annualized return is just 3.12 percent, far below the assumed rate. As of fiscal 2009, the state's employee and teachers' plans combined were just 58.5 percent funded, which translates to a deficit of $15.8 billion. Add in other postemployment benefits ($24.6 billion) and bond obligations ($18 billion), and Connecticut's debt equates to $17,628 for every man, woman and child living in the Nutmeg State.

In 2008, trying to prevent an even-worse pension shortfall, Connecticut — borrowing from the GM and New Jersey playbook — issued $2.3 billion in pension obligation bonds for its teachers' pension plan. Then last year, to cope with a general budget crisis, the state approved the Retirement Incentive Plan, with the unfortunate acronym of RIP.

Connecticut negotiated a deal giving certain unionized employees, including some part-timers, an additional three years' credit toward retirement.

The idea was to cut the state's payroll: The governor's office projected budget savings of $700 million if 3,000 employees took the offer. In fact, 3,856 did so, which increased the savings. The price, however, was adding to the burden on the state's already underfunded pension system.

As part of the negotiations, the unions allowed the state to forgo pension plan contributions of $50 million in 2009 and $64.5 million in 2010. Again, in easing its immediate budget woes, Connecticut added to the pressure on its pension plan.

The moves helped prompt Moody's to change its view on the state's financial picture last October. "With the sale of the $2 billion in pension obligation bonds on top of the state's normal annual sizable debt issuance," Moody's said in a ratings report, "Connecticut's debt ratio will likely remain among the highest in the country."

What's more, if the state were meeting actuarial requirements for retiree health insurance, "it would at least double the fixed costs . . . which were budgeted at $1.78 billion in fiscal year 2008," Moody's wrote. The ratings agency says Connecticut's postemployment benefits obligation now exceeds the state's annual operating budget.

If the problem posed by underfunded public sector pension plans is painfully clear, there are equally obvious solutions (see "Eight Ways to Avoid a Crash," page 37). That's the good news. The bad news is that they require steely will on the part of politicians faced with determined and organized public employee unions. Such courage is a rarity in the world of realpolitik.

Existing legal requirements don't help much. The ERISA law that sets strict funding requirements for private sector plans doesn't apply to the retirement plans of state and local governments. The absence of the stringent standards required in the private sector has the benefit of keeping the public sector's immediate costs relatively low, but it also allows funding levels to vary widely.

The Oregon state employees' and teachers' pension plans and the combined Florida state plans were more than 100 percent funded as of June 30, 2009, according to the National Association of State Retirement Administrators. As of the same date, however, the retirement plans for Oklahoma and Rhode Island teachers and public employees were only 57.8 percent and 53.4 percent funded, respectively. The Illinois teachers' plan was just 43 percent funded.

Funding levels will benefit from the nation's economic recovery, but that has been painfully slow. Meanwhile, the most likely near-term solution is for states to sell more pension obligation bonds, such as the $3.47 billion of paper floated by the state of Illinois early this year.

Pension obligation bonds can be a legitimate funding technique if they're combined with fundamental steps to put a state's pension plan on sound financial footing. But if history is a guide, pension obligation bonds often will be used to kick the funding problem down the road — at least, until investors stop buying the bonds. "California and other states don't have the ability to issue limitless amounts of debt," notes Horrocks, the Moelis investment banker.

There are nonetheless signs of new consideration being given to more-fundamental, tough-minded solutions, including reducing retirement benefits for public employees. It's a step that's almost impossible to apply to existing employees because public sector pensions are deemed by the courts to be contractual obligations. The U.S. Constitution prohibits the government from breaking contracts with its citizens unilaterally.

In general, the best that state and local governments can do is reduce pensions for new employees, and some are doing just that. As of the first of this year, New York State raised the age at which most employees can retire with full pensions to 62 from 55. Those who retire before 62 have their pensions cut by up to 38 percent.

New York also declared that new state employees must work at least ten years to qualify for a pension, up from five years. And the state limited the use of overtime pay in calculating individual employees' pensions — a major money-saving step.

The actual savings from New York's reforms, and similar moves elsewhere, won't be realized until newly hired employees start hitting retirement age, which will be 20 years or more down the line in most cases. But at least it signals the reversal of decades of mindless, continuing sweetening of public pension benefits. So do the moves afoot in several places to increase public employees' contributions to their retirement plans, reversing years of making those contributions lower.

The auto industry has set a positive example for state governments by adopting a Voluntary Employees' Beneficiary Association trust, which allows employers to prefund retirement health care benefits for employees on a tax-deferred basis. In 2007, with their own financial storm brewing, GM, Ford and Chrysler persuaded the UAW to establish a VEBA trust.

The move didn't come easily. Faced with the companies' request, the union hired Wall Street bankers to assess whether GM's financial plight was as bad as the company contended. The bankers replied that it was worse.

So the union accepted a VEBA, which relieved the companies of direct responsibility for funding retiree health care. Instead, the automakers make fixed payments to their VEBA trust funds, and the trusts now set benefit levels that the funds can afford. VEBA funds will save Detroit's automakers billions of dollars this year. They could do the same for states if public employee unions would agree.

Some believe the best option for state and local pension funds, however, will be shifting from defined benefit plans to 401(k)-type plans, as most of corporate America already has done. The major obstacle here isn't just public employee unions, but also the public employee psyche.

"Government workers tend to be older and less mobile"than their private sector counterparts, says Boston College's Munnell, "and they're usually more risk-averse as well." Many state and local employees tend to view a fixed pension as the trade-off for lower public sector salaries, even though the pay gap has been narrowing.

But signs of change are beginning to appear. The city of West Hartford, Connecticut, is currently in negotiations with its teachers' union to offer defined contribution retirement plans. Over the past decade or so, nearly one third of that state's municipalities have adopted defined contribution plans for employees, although in many cases the towns also retain defined benefit plans that cover employees hired before the change was made. Helping this transition is the fact that many younger public employees, unlike older ones, don't see themselves staying in the same government job throughout their careers.

Still, defined contribution plans, VEBA trusts and other reforms in the public sector will come slowly and haltingly — at least, until more public employees grow concerned that their government employers might risk going bankrupt, decimating their pensions and benefits in the process.

An American state seeking bankruptcy protection is unthinkable, of course. Just like, well, Wall Street coming to the brink of collapse on a September weekend.

Or like General Motors, once the biggest and richest company on earth, filing for Chapter 11.

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