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Lifting the state of siege on public-sector pension plans

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New Jersey, Illinois, Kentucky, Connecticut, Chicago, Detroit, Dallas: these are but a few of the states and cities making headlines because of uncontrollable pension underfunding that threatens the solvency of their retirement plans, the fiscal integrity of their governments, and the sacred promise made to their employees and retirees.

In their search for solutions, stakeholders have not utilized the public wealth at their disposal, beyond tax dollars, to formulate a financial resolution to this growing and intractable public crisis.

For the past 15 years, academics and financial analysts have warned about a worsening funding crisis among state and local defined benefit funds. According to the Center on Retirement Research at Boston College, public pension plans were underfunded in 2015 to the tune of $1.2 trillion (based on the average plan actuarial rate of 7.6%) and $4.1 trillion (using a less risky 4% corporate-like bond rate). The average funded ratio in CRR's public pension plan universe was 74% in fiscal year 2015 using actuarial rates. Among the 160 plans in CRR's database, 20.1% of plans were less than 60% funded, and 44% of plans were between 60% and 79% funded.

Plan contribution requirements are especially challenging for state and local governments that operate with annual balanced budget requirements. Again, CRR reports the 2015 required contribution as a percent of payroll in their public pension plan database was 18.6%, up from 12.5% in 2008 and 6.7% in 2001. This is not a sustainable trend. In some cases, states' and local government's pension underfunding threatens their credit ratings and potentially their ability to borrow. Just as important, the fallout surrounding the future of public pension plans has raised questions of public trust in the retirement institutions charged with the duty of delivering pension benefits to 35 million American workers and retirees.

There are multiple reasons for the public pension plan funding crisis. Two consecutive financial crises in the 2000s imposed dramatic asset drawdowns in all pension plans, both public and private, destroying trillions of dollars of retirement wealth. It took eight years for most plans to recover their 2007 asset values. These investment losses coincided with costly demographic trends, including an aging workforce and rising longevity. As plans mature, they are generating negative cash flow (annual benefit payments plus administrative expenses exceed annual employee and employer contributions), creating a further drag on funding progress. Finally, historically low interest rates have inflated plan liabilities and have raised serious questions about the reasonableness of funding assumptions greater than 7%.

Tapping public wealth

The inspiration for my proposal starts with a remarkable book, "The Public Wealth of Nations," written in 2015 by Swedish investment adviser Dag Detter and economist Stefan Folster. The authors estimate the world has $75 trillion in public assets that are unaccounted for on government balance sheets. These public assets include natural resources including land, forests, commercial real estate and minerals; infrastructure including ports, airports, canals, bridges; and equity in public enterprises. The authors suggest the fair valuation of these public assets would exceed 100% of annual GDP in many countries. In the case of the United States alone, that would mean public assets worth more than $18 trillion, four times the worst-case public pension deficit.

Reaching a 'grand bargain'

The first step in my proposal requires state and local governments to prepare a comprehensive balance sheet of all assets and liabilities, including real assets as recommended by Messrs. Detter and Folster. Once these hidden public assets are accounted for, I envision a "grand bargain" among the various stakeholders (legislatures, the executive branch, plan trustees and unions) where a portion of these unlocked public assets would be earmarked to pay off public pension plan shortfalls. This monetization of real public wealth could take place as a one-time transfer, or on a schedule of contributions dedicated solely to pay off pension legacy deficits. Another alternative would be for state or local governments to contribute in-kind real assets to their pension plans. In-kind contributions of real assets have been allowed in private sector pension plans under ERISA for 40 years. The U.S. Department of Labor has created a fair process for employers to make in-kind contributions to pension plans that meets fiduciary standards and prevents conflicts of interest.

Of course, the monetization of public assets for the purpose of pension funding or any other financial function of government must be depoliticized to avoid corruption, conflicts of interest and to protect the public at large. My proposal would create an independent commission in each state (referred to as the commission for public asset management) that would oversee the monetization of public assets for the purpose of benefiting the greater community. Think of the CPAM as a state's sovereign wealth fund.

Monetization of public assets does not automatically translate into privatization. Instead, the CPAMs could negotiate sales-leaseback arrangements with pension plans that avoid disrupting the use of public assets while at the same time protecting public sector jobs. Following the themes of Messrs. Detter and Folster, the public policy conversation would need to focus on how to improve the governance and yield on public wealth. A 1% yield improvement on U.S. public wealth in the U.S. could potentially earn $180 billion dollars per year, which would become available to fix difficult financial problems with social consequences, like retirement underfunding, and to finance badly needed infrastructure investments.

A unique opportunity

Funding pension legacy deficits offers a unique opportunity to restructure the nation's public pension system and transition to long-term financial sustainability. The "grand bargain" would set conditions on the transfer of public wealth to public pension plans. Plans that receive public wealth transfers would be required to negotiate specific conditions with their state sponsors. For example, public wealth transfer contributions could be utilized to derisk pension portfolios. This could be accomplished by investing the proceeds in a cash match portfolio that would cover all or a portion of the plan's accrued retiree liabilities. This would protect the fund from stock market crashes or significant market downturns, while at the same time enhance the benefit security of retirees. An additional condition would require the redesign of future service benefits into a risk-sharing defined benefit plan that uses lower hurdle rate assumptions for assets and liabilities. Such a plan would limit the risk of generating future unfunded liabilities, but it would still provide an adequate lifetime benefit.

By facilitating a reset of the public pension system, my proposal enhances the financial integrity of the public pension system, greatly improves retirement security and relieves fiscal pressures on state and local governments.

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