

Fitch Focus on Munis: Pensions

States Use Financial Engineering to Lower Contributions Comment

About Fitch Focus on Munis — *Fitch Focus on Munis* is a monthly report series that explores the critical issues faced by U.S. public finance.

Fitch Focus on Munis leverages our unique insights, backed by data, experience and a commitment to providing forward-looking analysis, to deliver an in-depth examination of emerging opportunities and challenges. In 2017, three issues merit closer attention:

- Healthcare.
- Pensions.
- Federal Policy.

Pensions

Governments often face a stark choice as they decide how to allocate their finite resources — provide for rising demands for healthcare, education, public safety and other public services, or set aside more funds to support pension systems that have suffered from underfunding, asset losses and unrealistic actuarial assumptions. State and local governments are taking steps today to reform pension benefits and make them more sustainable over the long run, but must still make good on the legally protected promises made to current and former employees. While pension challenges are manageable for most, credit quality may be at risk for governments unable to align spending with expected revenue growth in a way that is sustainable over the long term.

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Shifting Assets, Revenue to Pensions: Several governments have turned to financial engineering transactions to meet persistent challenges posed by their defined-benefit pension plans. Under these initiatives, a portion of a balance sheet cash pool or a future undesignated revenue stream is temporarily reallocated to their pensions to strengthen their plans' funded condition and slow the burden of rising contributions. Recent multibillion dollar transactions by New Jersey and California highlight the risk and benefits of these approaches.

Funding and Accounting Impacts Vary: Financial engineering transactions affect the funding valuations of pensions and the resulting actuarially determined contribution (ADC), but may not affect the accounting valuations that determine how pensions are disclosed in financial statements. Funding valuations are established individually according to each system's statutory requirements or board-established policies and typically reflect the full impact of financial engineering. Accounting valuations under GASB rules that guide pension reporting may recognize reallocated cash balances as an asset, while recognizing future revenue streams only insofar as they affect depletion date forecasts.

Risks and Rewards: Each transaction carries risks and rewards, for the primary government or the enterprise that foregoes an asset or revenue stream and for the pension system receiving it. Notable risks include the exposure of otherwise low-risk, liquid cash assets to higher volatility and potential losses within a pension investment pool, or the risk that the present value of a future revenue stream must be written down as tax or enterprise revenue streams underperform.

Traditional Reforms Insufficient: The appeal of financial engineering for pensions is driven in part by the inability of most traditional reforms to deliver near-term pension improvement and budgetary relief. Legal and political impediments to reducing accrued benefits mean that most reforms yield savings slowly and provide budgetary relief only if other long-term assumptions are met and contributions remain sufficient. Fitch Ratings cautions that financial engineering transactions, despite their attractiveness, are not a substitute for more fundamental reforms that correct an underlying sustainability problem.

Each Case Unique: The examples set by New Jersey, California and other government entities differ from one another materially, reflecting the nature and degree of their underlying pension challenges, the intent of the financing and the type of resources available to be reallocated. In assessing credit quality, Fitch evaluates these transactions individually to consider whether the transaction and associated pension changes raise additional risk factors for the primary government or enterprise being rated, or for the systems in which the rated entity participates. Fitch notes that regardless of how transactions affect the funding valuation, the agency will continue to rely on GASB-derived pension data when calculating each entity's long-term liability burden.

Limits to Reforms Driving New Strategies

Government pension sponsors have pursued numerous strategies for coping with rising unfunded pension liabilities and the resulting budgetary pressure of contributions. Virtually all have implemented reforms since the Great Recession lowering the cost of newly accrued benefits, making actuarial assumptions more realistic or improving often inadequate past contribution practices. These actions, while critical for long-term pension improvement, rarely produce near-term contribution savings given the strong legal protections afforded to already accrued benefits.

Governments have implemented other strategies to reduce contribution burdens, even if the underlying factors behind rising liabilities and contributions remain unchanged. These strategies include risk- and cost-shifting policies that allocate a higher share of contributions to employees or, for states, offload the cost of subsidized local pension benefits to local employers (usually school districts). Other strategies include external financing, with pension obligation bond (POB) proceeds deposited to the pension trust fund in a transaction designed to generate investment returns exceeding the cost of borrowing.

Leveraging an internal balance sheet asset pool or a future revenue stream to reduce contribution pressure is a new strategy that highlights the limitations governments face in finding other durable solutions to rising pension contributions. Recent transactions in the states of New Jersey (Issuer Default Rating [IDR] of 'A'/Stable) and California (IDR of 'AA-/Stable), detailed below, provide examples of these two strategies, and have been preceded by a handful of others. For example, both the cities of Jacksonville, Florida (IDR of 'AA'/Stable) and Pittsburgh, Pennsylvania (IDR of 'AA-/Stable), have used the recognition of future revenues to lower their unfunded liabilities in their funding valuations, and the University of California (general revenue bonds rated 'AA'/Stable) has borrowed portions of its available cash assets for its pension. Fitch expects to see more governments consider such transactions going forward.

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New Jersey Leverages its Lottery

New Jersey enacted the Lottery Enterprise Contribution Act (LECA) simultaneously with its fiscal 2018 budget. LECA irrevocably contributes the state's lottery enterprise to three of the state's five pension systems for a 30-year period. Although some aspects of LECA clearly support the stability of the state's unusually weak pensions, material long-term pension improvement is unlikely absent the state appropriating sufficient actuarial contributions.

LECA assumes a lottery asset valued at \$13.535 billion based on a separate present value analysis discounting cash flows at 7.65%, matching its systems' investment return assumption, and apportions that amount for funding purposes among the plans for teachers (77.78%), public employees (21.02%) and police and firefighters (1.20%). As of its July 1, 2016 funding valuation, the aggregate funded ratio for New Jersey's five pension systems (including two smaller, state single-employer plans) rises to 58.9% based on LECA, from 44.7%, excluding local governments in the plans.

The lottery asset is recognized at the outset of the 30-year period when calculating the funded ratio. Over time, net receipts from lottery sales, following prize payouts and administrative costs, flow on a monthly basis to each plan according to the same allocation percentages, even as the present value of the lottery enterprise is depreciated. The state's projections assume net lottery receipts rise at a relatively slow pace of 1.59% annually through 2029, and 1.00% thereafter.

Related Criteria

U.S. Public Finance Tax-Supported
Rating Criteria (May 2017)

Related Research

Pension Obligation Bonds (Weighing
Benefits and Costs) (March 2015)

During the first five years of the plan, forecast net lottery receipts do not supplement the expected state general fund contributions, but rather are netted from planned state contributions, leaving the transaction budget neutral. This period corresponds roughly with the final half of the state's 10-year phased climb to paying the full ADC. Fitch notes that the funded ratios of the plans will continue to erode over this period, even assuming that the plans achieve their 7.65% investment return assumption, a rate above the average for major state systems.

Over the remaining 25 years, a smaller, annual deduction is netted from planned general fund contributions. If state forecasts hold, rising net lottery proceeds exceed the deduction, providing additional resources to the plans in excess of the actuarial contribution, thus accelerating funding progress. No appropriation is required for the lottery deposits. Although net lottery receipts formerly flowed to education and other needs, New Jersey intends instead to direct general fund savings from the deduction for these purposes, limiting the transaction's impact on other state operations at least initially.

New Jersey estimates that its plans' funded ratios in aggregate will rise to 90% in 2047 under LECA, instead of 80% prior to the transaction. In contrast, LECA may have only a limited impact on its financial statements given that the \$13.535 billion lottery contribution is not likely to be recognized as an asset for financial accounting purposes. However, LECA delays slightly the plans' forecast depletion dates calculated under GASB 67 and 68, raising the blended discount rate and lowering the reported total pension liability (TPL). As of July 1, 2017, the state estimates the ratio of fiduciary net position to the TPL (including local governments in the plans) at 35.7% under LECA, up slightly from 35.1%.

California Taps Internal Cash

Under the "Pension Stabilization Plan" adopted by California with its fiscal 2018 budget, the state will borrow \$6.0 billion from over \$50 billion in internal surplus state cash balances — currently invested in state's portion of the Pooled Money Investment Account — for the California Public Employees' Retirement System (CalPERS) plan covering state worker retirements. Borrowed funds will be contributed in excess of the full actuarial contribution already contained in the budget, immediately increasing the plan's asset balance for funding valuation purposes (CalPERS uses market values for funding purposes, rather than smoothed values), raising the plan's funded ratio and lowering future actuarial contributions. California estimates the transaction will save it \$11 billion in contributions over the next 20 years. The loan will not affect the pensions of other governments managed by CalPERS.

Fitch views California as being well positioned to realize the plan's goals. The state's plan within CalPERS, with a funded ratio of 65.1% as of the June 30, 2016 valuation, is well above the levels reported by most other governments undertaking financial engineering transactions. The loan will be made in several installments over the first year to mitigate market timing risk as CalPERS deploys the proceeds into its investment pools.

Borrowed funds are forecast to earn CalPERS' investment return assumption at 7.375% in fiscal 2018, the first step of a three-year transition to a 7% rate in fiscal 2020. At this level, CalPERS' investment return assumption, while above the level assumed by Fitch in assessing pension risk, is below average for major defined-benefit systems. The loan balance accrues interest at the 2-year U.S. Treasury rate (currently 1.36%), above the yields on other state cash investments.

The loan is payable by 2030 from general and non-general fund resources, rather than from CalPERS. The general fund share is payable from debt repayment funds under Proposition 2, passed by voters in November 2014, which prioritizes the reduction of state liabilities, including

unfunded pensions. Achieving these goals is more likely given passage in November 2016 of Proposition 55, which elevated personal income tax rates through tax year 2030 in part to pay down state liabilities. The maximum term of the loan is 12 years, but the precise timing of repayment is not specified, and future state budgets could shift repayment depending on the availability of resources.

Although California's cash balances are economically sensitive, Fitch views the limited, \$6 billion draw as posing relatively little risk to overall state liquidity. Higher revenues from economic growth and recent temporary tax increases have substantially raised cash balances, lowered liabilities, and enabled the state to establish a sizable budget reserve balance, leaving it better positioned to absorb future volatility.

Fitch calculates California's pension liability burden as being above average for a state, but both the state and CalPERS have pursued significant changes to improve the likelihood of funding improvement over time. These include benefit reductions for new workers as of 2013; a shift to more conservative amortization, lower discount rates, and asset allocation changes intended to lower investment risk.

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