PUBLIC PENSIONS AND COVID-19:

Confronting a Crisis, and Opportunities for Reform

October 2020

INSTITUTE FOR
Pension Fund Integrity

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EXECUTIVE SUMMARY

The outbreak of the coronavirus pandemic over the last several months has caused worldwide economic, social, and political upheaval. After a decade of general growth, economies are now faced with a major contraction as social distancing becomes the norm and entire industries are forced to confront new realities. For public pensions, many of which were already struggling with staggering unfunded liabilities and other problems, this economic downturn presents a major challenge.

In this issue brief, we will examine the overall impact of the coronavirus on public pension plans across the country and evaluate the implications that it will have for future policy decisions. Our major takeaways include:

- The market downturn of the last several months has exacerbated the funding shortfalls facing many public pensions funds across the country, all but wiping out recent gains that had been made as a result of the strong economic growth of the past several years. Mismanagement and an unwillingness to implement reforms for years before this crisis has already put public pensions in a precarious position - before the crash, total state pension liabilities amounted to $1.24 trillion. This deficit has been compounded by a trend toward alternative investment products and strategies such as Environmental, Social, and Governance (ESG) criteria that have not been shown to yield the same level of returns as traditional or passive investments.
- This economic downturn will likely have a two-fold negative impact on public pensions. Firstly, the immediate market crash will greatly reduce investment returns. Secondly, broader job losses will reduce the tax base available to governments, limiting their ability to inject additional money into the funds. States and localities will be faced with difficult decisions regarding their continued ability to provide essential services and their drive to reduce pension fund debt.
- In the short- and medium-term, pension funds will have increased difficulties meeting their required contributions and other financial obligations, and many may also face a liquidity crisis. It is also unlikely that they will reach their set investment projections, which will necessitate reforms, and, in some cases, major overhauls of their investment strategies. These problems will be compounded by the economic recession that is likely to continue into the immediate future. In the wake of this crisis, other states should begin to implement similar stress testing requirements for pension plans.

In the face of these grave challenges, public pension fund managers are now in a position to implement long-needed reforms to their investment, management, and public policy strategies. This will be especially important for states and localities seeking federal assistance to shore up their pension funds. Based on IPFI's assessment, several steps can and should be taken to address these challenges:

Re-evaluation of risk and return assumptions

- The trend of making investments in riskier assets as a means of offsetting current shortfalls through higher expected returns in the future can have a tendency to backfire. Public officials should begin to move toward realistic actuarial assumptions when calculating future pension fund growth and the contribution levels that will be necessary to correct unfunded liabilities.

Re-emphasis of the fiduciary obligations of public pension fund managers

- In recent years, we have seen a concerning trend among some public pension fund managers choosing to prioritize political or social considerations when investing rather than putting beneficiary returns first and foremost. Calls for divestment from certain industries and a primary emphasis on environmental, social, and governance (ESG) investing may have immediate political benefits for certain public officials, but they do little to protect the long-term stability of pension funds or have the social impact desired. Now that many public pensions are anticipating a funding crisis far above and beyond what they had been previously anticipating, a return to the basic principle of fiduciary duty is warranted.

Expansion of stress testing

- The process of stress testing for pensions, by which simulations model the impact of certain economic conditions and other factors on the fund, are used to help policymakers develop a more comprehensive long-term strategy that will keep public pensions stable under whatever conditions may arise. However, currently only ten states have statutes in place that require stress testing for pension funds.

Reform of pension clauses in state constitutions

- Several state constitutions have clauses which prevent the reduction in pension benefit payments - provisions which are understandably very popular with government workers and beneficiaries, but which hinder the policy choices of public officials confronting liabilities. Given the nature of this economic crisis and the outsize impact that it will have on pension funding, public officials should use this opportunity to re-think the self-imposed restrictions that such constitutional provisions create.

OVERVIEW: IMPACT OF COVID-19 ON THE GENERAL ECONOMY

Since the end of 2019, the global threat of the coronavirus has brought the world economy to a standstill, with businesses forced to shutter out of concerns for public safety and millions out of work as a result. The financial markets have responded in kind - overall, the first quarter of 2020 showed a drop in the S&P of at least 20%.[1] While the market has recovered some of these losses since then with the lifting of the strictest lockdowns, the impact of the downturn is still being felt around the country and the world.[2] Bond yields similarly fell to a new low as the federal reserve has moved to lower interest rates.

Job losses have been extreme across the board, as many industries, but especially those reliant on public patronage and social gatherings, have had to consider major changes in their business models. Economic gains and new jobs created from the last ten years of a bull market have been effectively eliminated in a matter of weeks; since the start of the pandemic, over 50 million Americans have filed unemployment claims.[3] By August 2020, the unemployment rate sat at 8.4%, double from its peak low during the expansion period. Despite this, the market has rallied and swung unpredictably over the summer months, causing both periods of gains through August but a large selloff in early September, mainly of tech stocks.

According to research by the Mercatus Center, the real GDP growth rate can be expected to drop about 5% for every month of partial economic shutdown.[4] This represents an economic loss of over $1 trillion per month. A recent Equable Institute report shows that COVID-19 will bring the total pension debt to $1.62 trillion in 2020. These losses have yet to affect budgets, but increased pension bills are expected starting in 2021.[5]

Pensions before the crash

Before the crash, total state pension liabilities combined for $1.24 trillion. Five states: California, Texas, Illinois, Pennsylvania, and New Jersey's pensions account for over 50% of that total debt.[6]

In spite of the funding shortfalls that have faced many public pension funds in the years leading up to this pandemic, a long-running bull market was helping to close the liability gap. According to the Milliman Index, the 100 largest public pension funds in the United States had an overall funding ratio that grew from 67.2% at the end of 2018 to 74.9% in December 2019.[7] This represents the highest overall funding ratio since 2016. Total liabilities also shrunk in 2018, down from $1.35 trillion in 2016 and 1.28 trillion in 2017 respectively.

Over the past several decades we have seen a shift in pension investment away from relatively safe holdings and toward riskier assets. This has been done largely as a way to boost the estimates for future rates of return, thus reducing the need for fund managers to make up for growing liabilities in the short-term. While investing in riskier assets such as hedge funds, private equity, and "alternative" investments can have the potential to increase returns, they are also hit especially hard during economic downturns.

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1 https://www.mercatus.org/system/files/biggs_and_norcross_-_policy_brief_-_covid_series_-_public_sector_pensions_and_the_covid-19_shock_-_v1.pdf
2 https://ycharts.com/indicators/sp_500_monthly_return
3 https://www.wsj.com/articles/jobs-report-unemployment-benefit-claims-coronavirus-08-06-2020-11596675422
4 https://www.mercatus.org/system/files/makridis-cost-covid-19-mercatus-v1.pdf
5 https://equable.org/wp-content/uploads/2020/08/Equable-Institute_State-of-Pensions-2020.pdf
6 https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2020/06/the-state-pension-funding-gap-2018
7 https://www.milliman.com/en/insight/Public%20Pension%20Funding%20Index%204th%20Quarter%202019

Even in the wake of the Great Recession, public pension fund managers have continued to follow this trend - from 2008 to 2018, the average amount of assets held by state and local pension in stocks, alternative investments, commodities, or real estate grew from 70% to 74%.[8] (As a point of comparison, in 1942 state pensions invested 90% of their funds into federal, state, and local bonds).[9]

Preliminary assessment of the market crash on public pensions

Because of the day-to-day ramifications of the coronavirus on the global economy, it is difficult to measure the immediate impact that the downturn has had on public pension funds. However, preliminary analysis begins to outline the scope of the problem. According to Moody's, public pension investment losses across the board approached $1 trillion at the end of March, representing a 21% loss for the fiscal year.[10] This loss comes on top of the $4.1 trillion shortfall among state and local pensions that existed before the crash.[11] Even with gains in the second quarter, year-to-date returns among public pension plans average just 3.84% according to the Milliman 100 Public Pension Funding index - far lower than the anticipated levels needed to meet funding goals.[12]

Unfortunately, the crisis of unfunded pension liabilities has for the most part remained unchecked in the decade since the last financial crisis. While a limited number of states boast fully funded public pensions, and may weather this downturn with limited consequences, states which were already facing dire funding prospects such as Kentucky, New Jersey, and Illinois are now in even greater trouble. A new report from Moody's Investors Service indicates that public pension liabilities will balloon to $1.62 trillion in 2020, up from $1.35 trillion in 2019. Many governments also have less capacity to defer cost hikes or take other mitigating actions than they were after the financial crisis of 2008, due to the fact that their non-asset cash flow relative to assets has greatly dropped or become negative - another indication of neglected reforms and kicking the can down the road.[13]

At the state level, data on the effect of COVID-19 has begun to emerge. In California, the effect of the downturn on an already strained public pension system has been especially pronounced. At the end of the first quarter, the California Public Employees' Retirement System (CalPERS) reported that their asset value had dropped 10.5% since June 2019 - a loss of around $35 billion.[14] This comes off of the working assumption among CalPERS fund managers that investments would grow by 7% this fiscal year.[15] Mismanagement from leadership, including the resignation of Chief Investment Officer Ben Meng, leaves the pension's future hanging in the balance with a lack of clear direction moving forward. In states such as Illinois, a rising pension problem is turning into catastrophe. The state has assumed a 7% annual return rate in its investment planning, but Moody's estimates that the state's pension liability, largely due to the COVID-19 pandemic, will rise from $230 billion in 2019 to $261 in 2020.

Similarly, after the market crashed following announcements of COVID-19 in the U.S., Kentucky Retirement Systems' (KRS) returns finalized at negative 7%. KRS has a tumultuous history balancing its books, with $25.8 billion in unfunded pension liabilities. For the 2020 fiscal year, KRS's U.S. equities portfolio produced a 4.7% return, below the 6.5% return of the Russell 3000 Index, one benchmark for the American stock market. In addition, many of KRS' alternative investments, such as hedge funds of funds, lost money for the year.

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8 https://www.mercatus.org/system/files/biggs_and_norcross_-_policy_brief_-_covid_series_-_public_sector_pensions_and_the_covid-19_shock_-_v1.pdf
9 https://www.washingtonpost.com/outlook/2020/04/17/next-covid-19-victim-public-pension-funds/
10 https://www.marketwatch.com/story/market-rout-leaves-public-pension-funds-nursing-a-nearly-1-trillion-loss-for-fiscal-2020-moodys-2020-03-24
11 https://finance.yahoo.com/news/public-pensions-face-reckoning-equity-173508447.html
12 https://www.pionline.com/pension-funds/public-pension-funding-jumps-712-q2-milliman
13 https://www.ai-cio.com/news/us-public-pensions-lose-1-trillion-market-crash/
14 https://reason.org/commentary/covid-19s-negative-impact-on-public-pension-systems/
15 Ibid

WHAT ARE THE RAMIFICATIONS OF PENSION SHORTFALLS?

Difficulties making required contributions

Major economic downturns such as this one have a two-fold negative impact on public pensions. First, the immediate market crash will greatly reduce investment returns. Second, broader job losses will reduce the tax base available to governments, limiting their ability to inject additional money into the funds.

States and localities will be faced with difficult decisions regarding their continued ability to provide essential services and their drive to reduce pension fund debt. As expected, this challenge will be felt the hardest in the states with the most underfunded systems - in Illinois for example, 20% of state tax dollars already went toward pension fund contributions before the crash.[16]

This economic crisis will necessitate major investments by states and localities in critical services, but public officials must be aware of the medium and long-term consequences of reduced pension contributions. To meet requirements, pension payments will need to be boosted in the coming years, likely resulting in reduced services for taxpayers, limited salary increases for public employees, and, in some cases, public sector layoffs.

States such as California, which already heavily rely on taxing income, are also finding an ever-shrinking tax base from which to pull. This has led to calls for increased taxes, primarily adding 1%, 3%, and 3.5% surcharges on the 13.3% top marginal tax rate for earners making more than $1 million, $2 million, and $5 million respectively. These higher tax rates, in a state already infamous for high taxes, reflect the challenging landscape facing pensions. States can't have everything, and the delicate balance between spending on services and pensions, as well as not taxing too much, has been pulled into sharper focus by COVID-19.[17]

Rethinking Investment Projections

With the crisis of pension fund liabilities continuing to grow in recent years, many states have turned to overly optimistic projections of investment returns as a means of avoiding taking meaningful action. According to data from the Boston College Center for Retirement Research, the largest public pension plans have earned average returns of 5.9% since 2001, while at the same time assuming rates of return upwards of 8% in some cases.[18] Through these over-estimations of future growth, states and localities have been able to defer future contributions and the implementation of major reforms. While this approach may have been politically convenient in the short-term, it is now clear how precarious it was in the face of an economic crisis. If a decade of strong economic growth in the run-up to COVID-19 was not a great enough return on investment for pension funds to make up their losses, a new approach is needed.

The good news is that even before the coronavirus crisis, many pension fund managers were revising their approach and lowering expectations for rates of return.[19] Public pensions are by their very nature long-term investments, but there is a major difference between planning ahead and putting off responsibilities for the sake of short-term political convenience.

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16 https://www.pewtrusts.org/en/research-and-analysis/articles/2020/04/23/how-the-market-downturn-could-affect-public-pension-funds
17 https://www.cnbc.com/2020/07/30/tax-hike-on-california-millionaires-would-create-54percent-tax-rate.html
18 https://crr.bc.edu/wp-content/uploads/2019/08/SLP68.pdf, https://ipfiusa.org/2020/03/20/fallout-from-covid-19-demonstrated-rose-colored-perspective-on-pension-returns/
19 https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2019/12/state-pension-funds-reduce-assumed-rates-of-return

States that have well-funded pension systems have the most to lose with increases in unfunded liabilities. Pension plan earnings will fall short of where they need to be to keep their funded ratio flat in 2020. The median long-term expected rate of return is 7.25%. This is problematic because when states miss their targets and unfunded liabilities increase, it will burden the taxpayer. In efforts to stabilize pension systems, states will either increase taxes or make cuts into its services. In 2016, Chicago increased property taxes to generate an additional $588 million more per year to put into its pensions systems. Meanwhile, Kentucky cut spending on education and health and human services to redirect money into its retirement system. State lawmakers will have to deal with budget shortfalls for at least two more years, especially for states with fragile but not distressed pension plans.

The Disproportionate Impact of COVID-19 on Pensions for Women and Minorities

Well before COVID-19, women faced retirement with less savings than men. There is tangible research that shows there is a wage gap amongst men and women which widens depending on race and ethnicity. Data from the 2018 U.S. Census Bureau shows that for every dollar a white man makes, an Asian woman will make 90 cents, a white woman 79 cents, a black woman 62 cents, a latina woman 54 cents, and a native woman 57 cents.[20] It is important to take note that this gap remains true regarding pensions.

During normal times, women take more time out from the workforce, resulting in diminished pension pots. As a response to the COVID-19 crisis, policymakers have granted beneficiaries early access to their retirement funds, raising the question if women are depleting their savings.

Catherine Collison, the CEO of the Transamerica Center for Retirement Studies (TCRS), states: "Any disruptions in employment, income, and access to benefits for women are likely to widen the gap. Furthermore, given long-standing societal roles, women may find themselves more involved in homeschooling their children or being called upon to be a caregiver for an aging parent or loved one."[21]

A TCRS study finds that after the U.S. economy was temporarily shut down, 25% of women said their confidence in their ability to retire had dropped during the pandemic, compared to 21% for men. It was also found that some 39% of women are not planning for retirement, compared to 22% for men.[22]

COVID-19 and Multiemployer Pension Plans

The Retirement Security Coalition is setting off alarms about the current financial state of multiemployer pension plans. They represent a large number of blue collar workers, and they argue that legislation on pension reform is urgently needed.

So far in 2020, 117 multiemployer pension plans have submitted notice of critical declining status, and seven of which have already been granted clearance to cut benefits to 35,173 participants. It has been projected that the Central States Pension Fund, one of the largest in the country, will collapse by 2025 without future action. This collapse will then trigger the insolvency of the federal insurance agency, the Pension Benefit Guaranty Corporation, within the next five years.[23]

A study conducted by The New School, found 2.9 million workers between the ages of 55 and 70 have left the workforce since March. This age group will experience a 41% wage decrease if they regain employment.[24]

20 https://www.americanprogress.org/issues/women/reports/2020/03/24/482141/quick-facts-gender-wage-gap/
21 https://www.advisorperspectives.com/articles/2020/08/19/some-of-the-worlds-biggest-pension-systems-are-failing-women
22 https://transamericacenter.org/docs/default-source/retirement-survey-of-workers/tcrs2020_sr_women-and-retirement-amid-covid19.pdf
23 http://www.pensionrights.org/publications/fact-sheet/pension-plans-have-applied-cut-benefits-under-multiemployer-pension-reform-a
24 https://www.economicpolicyresearch.org/jobs-report/over-half-of-older-workers-unemployed-at-risk-of-involuntary-retirement

Liquidity

Fallout from this economic crash will likely require a re-evaluation of how pension managers determine the necessary level of liquid assets in their funds. On average, public pension plans in the U.S. have around 1% of their assets held in cash and short-term investments in order to manage ongoing expenses such as administrative costs and payouts to beneficiaries.[25] While this percentage seems low, under normal economic circumstances the amount of liquid assets on hand isn't much of a problem as they are supplemented by investment returns. However, during major downturns this can become an issue, potentially forcing pension funds to sell non-cash assets to make up for the shortfall, further exacerbating their funding problems.

Potential Long-term Recession

Unfortunately, even when the immediate threat from COVID-19 subsides, the economic recovery will not be immediate. The re-opening of business and society will be a very gradual process, with some forms of social distancing in place for the medium and long-term. Cycles of reopening, outbreaks, and shutdowns are likely to occur long-term until treatments for COVID-19 are available and the public regains confidence that life can be carried on similar to the pre-pandemic. Until a vaccine is ready and made widely available, entire sectors of the economy that rely on social interaction and bringing large crowds together will remain scaled back as consumers continue to exercise caution. With this recession on the horizon, public pension funds should not expect to see a return to the promising levels of steady growth that they experienced in the first quarter of 2020 anytime soon. Growth in certain sectors, such as tech, have occurred, but overall expansion has been relatively uneven and inconsistent.

Facing this new economic reality, actions taken in the coming months will demonstrate the commitment of policymakers around the country to fully fund their pension obligations. In the past, in downturns such as this one, public pension needs have often taken a back seat to other, more "immediate" policy concerns as the demand for resources grows. The political pressure from these different priorities will lead to many difficult decisions. However, ignoring pension funding obligations in this time of need will only exacerbate the underlying liabilities problem even further.

25 https://www.ai-cio.com/news/terrible-time-pensions-weak-liquidity/

WHAT POLICY REFORMS SHOULD WE SEE MOVING FORWARD?

Potential bailouts

Given the precarious position of public pension funds in the aftermath of this economic downturn, it is likely that more and more states will inevitably turn to the federal government for assistance. This has already been the case in Illinois, where the President of the State Senate has called for $40 billion in general assistance, $10 billion of which would go toward pensions.[26] In New Jersey, State Senate President Stephen Sweeney has called for the establishment of a $500 billion federal loan program for state pensions.[27]

In general, any federal action to rescue already-underfunded pensions would be subject to severe political backlash, seen as a bailout for ill-managed funds and fund managers that never wanted to take action to address their own problems in the first place. However, despite the political consequences, the scale of the problem may be such that federal intervention is inevitable in many instances at the risk of insolvency. If this is the case, it presents the opportunity for the federal government to make demands for meaningful reforms that public officials have up to now refused to consider.

The federal government provided significant aid to state and local governments in the CARES Act that was passed in late March 2020.[28] This included $150 billion for state and local governments, but Congress has since failed to come to a compromise on further necessary aid. State governments generally cannot run a deficit, so aid from the federal government will be necessary for governments hoping to mitigate extreme spending cuts. Funding for state and local governments is politically controversial, but without it states will be facing a hard set of choices.

State Bankruptcy

Senate Majority Leader Mitch McConnell has suggested letting states go bankrupt in response to the current pension crisis. He argued that instead of having the federal government bail out states, they should go bankrupt - especially states with hard-hit pension funds such as Connecticut, Massachusetts, New Jersey, Louisiana, and Illinois.

Dr. Walter Lane, chair of the economics department at the University of New Orleans and an expert in state bankruptcy, writes that the states considering bankruptcy are the same ones which face enormous pension commitments. If this is the case, beneficiaries of public pensions could have their benefits cut entirely.

Since state bankruptcy is currently prohibited, the state would have to follow a lengthy process that would eventually end up at the Supreme Court.[29] The other way a state could go bankrupt is if Congress passes new legislation.

Dr. Lane explains that the first move before bankruptcy is to cut state programs such as Medicaid and higher education. The state could also liquidate its parks and buildings. In 2010, amid a fiscal crisis, Arizona sold off nine historic sites, including its Supreme Court, House, and Senate buildings.

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26 https://www.nytimes.com/2020/04/17/business/dealbook/illinois-pension-coronavirus.html
27 https://www.nj.com/coronavirus/2020/04/feds-need-to-help-nj-public-worker-pension-system-survive-coronavirus-crisis-sweeney-says.html
28 https://www.congress.gov/bill/116th-congress/senate-bill/3548/text?q=product+actualizaci%C3%B3n
29 https://www.radio.com/wwl/articles/state-bankruptcy-a-solution-to-the-covid-19-economic-defici

Even though letting states go bankrupt is a last-ditch effort, the Constitutional validity of such an action would be questioned. The National Governors Association has asked for an additional $500 billion in assistance in response to the shedding of 1.2 million jobs from local governments.[30] Presidential candidate Joe Biden argues that these jobs could be saved if the federal government increases its deficit. One of the primary disagreements Republicans and Democrats have is over how much assistance states should receive; while Democrats call for $950 billion, the White House has offered $150 billion.[31]

Re-emphasis of fiduciary responsibility

Public pension fund managers have an obligation of fiduciary duty to their beneficiaries, meaning that they are required to make investment decisions that seek to maximize returns rather than pursuing any alternative agenda. In recent years, we have seen a concerning trend among some public pension fund managers choosing to prioritize political or social considerations when investing rather than putting beneficiary returns first and foremost. While individual investors are free to make these kinds of decisions when choosing where to put their money, pension fund beneficiaries have no say in where their pension funds are invested while they also lack the ability to move their money if they disagree with its management. Calls for divestment from certain industries and a primary emphasis on ESG investing may have immediate political benefits for certain public officials, but they do little to protect the long-term stability of pension funds or have the social impact desired. Because of this, fiduciary duty and a singular focus on maximizing returns is paramount.

One glaring example of this disparity is the California Public Employees' Retirement System (CalPERS), the nation's largest public pension fund with around $400 billion in assets.[32] In recent years, the fund has seen a renewed emphasis on environmentally focused investments coupled with rapidly growing funding liabilities; according to an American Council for Capital Formation study, the fund went from having a $3 billion surplus to a $140 billion deficit over a ten-year period.[33] While a variety of factors contributed to this dramatic decline, CalPERS has drawn pointed criticism over the fact that its beneficiaries have been deprived of more stable financial returns at the expense of disproportionate investment in green industries. This criticism echoes research put forward in a recent IPFI report, which notes that ESG funds have not been shown to garner the same financial returns as investments in passive index funds.[34] Similar choices, such as pulling out of a specific firm's stock, also disregard one's fiduciary duty and should be avoided. As a point of comparison, in fiscal year 2019, CalPERS averaged a 6.7% annual return.[35] At the same time, both the S&P 500 index and the Vanguard 500 index fund yielded returns of over 30%.[36]

In the wake of the COVID-19 economic downturn, there has been a renewed push for the inclusion of ESG products in pension investment strategies, with proponents claiming that such funds have been outperforming traditional investment products in the wake of the crisis. Despite the tumult in the markets over the past several months and the economic upheaval that many industries have been forced to confront, new research has shown that this is not the case. According to a report from several academics from the Netherlands, UK, and U.S., not only have ESG scores offered very limited explanation of positive returns during the pandemic, they have also failed to shield funds from declining share prices.[37] The researchers note that more traditional metrics such as debt levels, liquidity, and profitability remain the most precise indicators of a firm's ability to maintain and increase shareholder returns.

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30 https://www.nga.org/news/press-releases/national-governors-association-leadership-urges-senate-to-approve-state-stabilization-funding/ ; https://www.bls.gov/news.release/empsit.nr0.htm

31 https://www.businessinsider.com/joe-biden-mitch-mcconnell-federal-aid-states-coronavirus-relief-2020-9

32 https://researchcenter.pionline.com/v3/rankings/plan-sponsors/profiles/429675/overview

33 https://accfcorpgov.org/wp-content/uploads/2017/12/CalPERS-Report-Final.pdf

34 https://ipfiusa.org/2018/09/25/ipfi-esg-investing-for-public-pensions-does-it-add-financial-value/

35 https://www.pionline.com/pension-funds/calpers-reports-67-annual-return-misses-benchmark

36 https://dqydj.com/2019-sp-500-return/#:~:text=The%20S%26P%20500%20Price%20index,the%20S%26P%20500%20returned%20 33.07%25., https://investor.vanguard.com/mutual-funds/profile/performance/vfinx/cumulative-returns

37 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3675920&_sm_au_=iVVVDp4k5DSLqML601TfKK3Qv3fc4

Dr. Ellen Wald, a senior fellow at the Atlantic Council's Global Energy Center, notes that "ESG is really pushed by financial firms eager to sell a new idea, and charge higher fees, and there is no universal criteria for what qualifies a company to be included in an ESG fund. The criteria for ESG are subjective and amorphous, meaning public pensions and public employees are not assured that their investments are actually avoiding unjust activity just because they are placed in ESG funds."[38] This ambiguity surrounding how ESG products are defined has also been discussed in a recent IPFI issue brief, and is a key issue that should be addressed before broad claims can be made about the effectiveness of ESG as an investment strategy.[39]

Now that many public pensions are anticipating a funding crisis far above and beyond what they had been previously anticipating, a return to the basic principle of fiduciary duty is warranted. Fund managers will need to do all that they can in the coming months and years to make up for the losses incurred by the coronavirus, and a straightforward commitment to overall investment returns rather than unproven strategies such as ESG prioritization would be a step in the right direction.

Re-thinking assumed returns and risk

If there is one takeaway for public pensions that can already be gleaned from this crisis, it is that the trend of making investments in riskier assets as a means of offsetting current shortfalls through higher expected returns in the future can backfire tremendously. The concept of risk in investing works both ways - greater potential gains, but also greater potential losses. Unfortunately, the projections made by pension fund managers seemed to not factor in any sort of economic crisis or recession. This was an incredibly short-sighted determination, which IPFI discussed in a recent blog post.[40] Public officials should begin to move toward realistic actuarial assumptions when calculating future pension fund growth and the contribution levels that will be necessary to correct unfunded liabilities.

As an example of a shift toward safer investments, the state of Pennsylvania recently dumped $2 billion in risky investments from its Pennsylvania School Employees Retirement System (PSERS). More moves like this will help make pensions sturdier for many decades

Stress testing

The process of stress testing for pensions, by which simulations model the impact of certain economic conditions and other factors on the fund, are used to help policymakers develop a more comprehensive long-term strategy that will keep public pensions stable under whatever conditions may arise. However, currently only ten states have statutes in place that require stress testing for pension funds.[41] These states are clearly better positioned to adjust their projections and implement other forward-thinking policies that will stabilize state and local budgets; unfortunately, it seems that everyone else is ill-prepared. With the reality of this economic crash now very apparent, other states will hopefully start to implement similar stress testing requirements for pension plans.

Some states have expressed concerns over stress testing. Testing is not free and costs can vary widely depending on the contract and size of the pension.[42] Investing in pensions' stability now, however, rather than facing the economic consequences later, is always favorable. Concerns over the results of stress test results also exist, although there are diverging views. Either way, knowing the limits of public pension systems is important, and more states should be looking toward proactive solutions such as stress testing for the stability of their pensions.

38 https://www.realclearmarkets.com/articles/2020/09/11/correcting_the_myths_on_the_labor_departments_esg_rule_577077.html
39 http://ipfiusa.org/wp-content/uploads/2020/08/IPFI-Issue-Brief-Defining-ESG.pdf
40 https://ipfiusa.org/2020/03/20/fallout-from-covid-19-demonstrated-rose-colored-perspective-on-pension-returns/
41 https://www.pewtrusts.org/en/research-and-analysis/articles/2020/04/23/how-the-market-downturn-could-affect-public-pension-funds
42 https://www.ncsl.org/research/fiscal-policy/public-pension-stress-testing.aspx

Re-examining pension clauses in state constitutions

Several state constitutions have clauses which prevent the reduction in pension benefit payments - provisions which are understandably very popular with government workers and beneficiaries, but which hinder the policy choices of public officials confronting liabilities.[43] Given the nature of this economic crisis and the outsize impact that it will have on pension funding, public officials should use this opportunity to re-think the self-imposed restrictions that such constitutional provisions create.

Strong economic growth has historically often emboldened state governments to expand pension benefits, assuming that their inflated return estimates, booming economy, and tax base will support them in this endeavor. In 1989, Illinois passed a law that started a 3% compounding increase in benefits for retirees—all while not being tied to inflation.[44] In 2002, the state passed an early retirement plan that allowed public employees to retire at 50 with full benefits.[45] Moves such as this have only deepened the state's pension crisis. In economic downturns the underlying instability of these extended benefits is exposed. States must not only rethink their clauses that protect public employees' retirements, they also need to more critically approach legislation that aims to expand benefits when those decisions cannot so easily be reverted.

43 https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2019/05/legal-protections-for-state-pension-and-retiree-health-benefits
44 https://chicago.suntimes.com/2020/8/26/21402853/illinois-public-finances-debt-speaker-madigan-pension-debt-illinois-policy-institute
45 Ibid.

CONCLUSION

Unfortunately, the new challenges that public pension funds will have to confront in the months to come are not a direct result of the fallout from coronavirus, but rather an extension of the problems that they have failed to adequately address up to this point. Funding challenges and liabilities are a daunting public policy challenge in times of positive economic growth - during downturns, they can become nightmarish. If our public pensions are to achieve some level of stability for generations to come, difficult political decisions will need to be made.

Coca-Cola's Vice President, John Murphy, spoke on retirement security at the 2020 Democratic National Convention (DNC).[46] Murphy adds a personal connection to the pension crisis, recalling a recent visit to Buffalo, NY where he spoke to a retiree who told him he would have to put his wife - who suffers from multiple sclerosis - in a Medicaid nursing home if his benefits are slashed. In this case, the retiree did everything right, yet policy still failed him.

If there is any silver lining to this crisis, it is that struggling states and localities may now finally be forced to make the changes that they have put off for years. Responsible decision making in the present may lead to some electoral losses, but responsible management of public pensions in the long-term will best serve the dedicated public servants who have spent their lives paying into these funds.

46 http://njtoday.net/2020/08/20/teamster-warns-of-pension-woes/

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