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What COVID-19 Means for the Future of Public Pensions

Introduction

It remains uncertain on Capitol Hill as to whether a relief bill will pass that provides COVID-19 relief to municipalities that are experiencing large budget gaps. In the meantime, cities, towns and villages are taking actions to maintain good fiscal health and credit stability, particularly related to pension funding. While many cities began 2020 with growing reserves, the COVID-19 pandemic has devastated city budgets, where reserves will likely be insufficient to offset a prolonged recession.[1] Cities' carefully built reserves are being depleted from unexpected and unbudgeted COVID-19-related expenditures, and with no federal relief on the horizon, cities and towns will need to make cuts that may sting for years to come.

Even before the pandemic hit, pension funding had not completely recovered from the Great Recession of 2007-2009, as investment returns and subsequently pension funded ratios fell substantially, leading to changes in pension plan structures that have lasted well beyond the recession.[2] One way to look at this is the average public Defined Benefit plan funded ratio—the total value of a plan's assets weighed against its accrued liabilities—dropped from 86 percent in 2007 to 72 percent in 2019.[3] While nationally, on average all pension systems took a hit, those that were already less well funded experienced a greater reduction in their funded ratio. The gap between the top third best funded and bottom third worst funded systems increased from 20 percent in 2001 to 35 percent in 2017.[4] For example, municipal pension systems in cities like Los Angeles and Wichita, KS still maintained funded ratios over 90 percent in 2019, whereas cities like Charleston, WV and Chicago had ratios of 11 and 23 percent, respectively.

After the dust from the recession began to settle, in 2019 state and local pension plans on average assumed their portfolios could earn over seven percent annually. But once COVID-19 took hold, actual investment returns amounted to just 3.2 percent in fiscal year 2020.[5] With 70 percent of cities believing their financial health has been negatively impacted by the pandemic, there is some consensus that this trend will continue.[6] Despite this, most local government pension plans are still expected to be able to pay benefits at their current contribution levels.[7]

However, strains on government finances due to the current recession could make it harder for localities to pay their required contributions. Many public pension plans could require long-

About the Authors: Joshua Pine is specialist, Rose Kim is research specialist, and Anita Yadavalli is program director of City Fiscal Policy in NLC's Center for City Solutions. The authors are grateful for the guidance and review from ICMA-RC.

term higher pension contributions due to reduced pension plan contributions in fiscal year 2021 and beyond due to the unexpected COVID-19-related expenditures and revenue shortfalls, the latter of which were not covered by the Coronavirus Aid, Relief, and Economic Security Act, or the $2.2 trillion federal economic stimulus bill passed by Congress in late March. This could result in higher taxes or cuts to certain services to pay for higher pension contributions. As these challenges become more apparent, local elected officials have an increased responsibility to ensure the health and viability of their pension plans. This brief equips city leaders with an understanding of the city-state relationship heading into the COVID-19 pandemic, and best practices as cities navigate this financial and health crisis and prepare for the future.

City-state relationship before the pandemic

Well before the COVID-19 pandemic, increasing tensions between state and local governments fostered a distrust among local elected officials of their state retirement systems.[8] This sentiment was particularly heightened in cities in Illinois, Kentucky, New York and California. Meanwhile, particularly since the Great Recession, most state and local governments have introduced reforms to their retirement plans, furthering the uncertainty among employees over how to save for their future. Whereas only five states introduced pension reforms in 2005, that numbered jumped to 27 in 2011.[9]

These reforms included making riskier investments to compensate for lower employer contributions given decreases in government revenue. Public pension investment in alternative investments—such as in private equity, hedge funds, real estate and commodities—increased from nine percent in 2005 to 24 percent in 2015.[10] After the Great Recession, 17 states decreased their cost-of-living adjustment for pension benefits, which have largely been upheld as legal measures in court.[11] Despite many of these reforms, however, states have required increased pension contributions that have led some states, such as Illinois, to cut core services by a third from 2000-2019.[12]

Some states were able to get ahead and plan for future economic downturns. The state of Virginia conducted a stress test of its pension system in 2019, when its funded ratio was 77 percent. The test predicted that if the market were to experience a drop similar to that experienced during the Great Recession, the system's unfunded liabilities would double and hit $12.5 billion.[13] These projections also suggested that local governments would be hit particularly hard, which could lead to serious cuts in essential services and programs. Attempts were made to diversify the pension investment portfolio to mitigate risk based on this stress test, although it was acknowledged that it would have a limited effect in the face of a serious market downturn. The detrimental financial impact of the pandemic on state and local governments will only exacerbate this trend as cities are forced to decrease spending on essential services which are needed for recovery efforts.[14]

While pension plans with very low funded ratios tend to garner most of the public spotlight, many more plans are better funded and financially stable, with municipal pension plans funded at an average of 72 percent as of 2019.[15] Most jurisdictions participate in the state retirement system and are required to make pension contributions to that system.

Nearly
60 percent
of cities and other local governments are required to make pension contributions to the state retirement system to which they belong.[16]

While states like Kentucky, Illinois and California have undoubtedly struggled to pay down unfunded liabilities, many localities continue to be good actors by making sufficient contributions into their state retirement system. In fact, many municipalities have had to increase contributions from their own general fund in recent years to support their state's system. Despite these increased contributions, if the pension funded ratio falls during the pandemic-induced recession, due in part to actual investment returns being lower than projected, state and local governments may choose to adjust plan structures as they did after the Great Recession.[17] Public pension plans can be expected to continue to reduce investment return assumptions and examine their funding amortization periods. Plan sponsors may continue to consider implementing changes to plan designs, such as lowering benefit levels, shifting more risk to employees, and increasing employees' required contributions.[18]

Best practices amid the pandemic

As cities grapple with weakening public pension systems as a result of the COVID-19 pandemic-induced recession, local elected leaders have the opportunity to identify, influence and implement the following pension plan management changes, which state and local governments are using to mitigate financial losses from the economic downturn and provide cushion for the future:[19]

- Implement mandatory stress testing as required by new actuarial standards
- Fund at sufficient contribution levels to reduce unfunded pension obligations
- Develop robust cost-sharing mechanisms and benefit design features

Mandated according to Actuarial Standard of Practice No. 51, stress testing is an effective risk management tool involving assessment of the vulnerability and sustainability of the current pension plan and evaluating the impact of potential pension reforms.[20] Eleven states have adopted legislation or enacted statutes that require stress testing for public pension systems.[21] And for the remaining states that do not use stress testing, localities within those states have, in order to identify risks.

For example, the city of Houston, Texas conducted a stress test study in early 2020 that revealed the city's inability to effectively handle a recession due to its structurally-imbalanced finances. Although the city is struggling with budget deficits, revenue shortfalls, and government employee layoffs and furloughs, Houston was able to identify and address its vulnerabilities pre-pandemic, focusing on designing a structurally-balanced budget through conservative budgeting practices that involved a buildup of cash reserves and the city's savings account.[22]

In Austin, Texas, the city council created a plan to address the balance sheet of its distressed employee retirement system, which is funded at about 68 percent. The plan includes enacting a flexible contribution policy to manage risks and liabilities, amending benefit policies to match the system's obligations for expected contributions, and improving risk-sharing between the city and its employees.[23]

Some communities are funding pension plans at sufficient contribution levels to reduce unfunded pension liabilities. This is an effective yet simple way to determine the effectiveness of different funding policies—such as contributions that are fixed based on a percentage of workforce payroll vs. contributions that adjust regularly based on experience—to improve funding levels and increase resiliency, especially during an economic recession.[24] Maintaining underfunded pension plans and failing to reduce pension debt can result in higher employer contributions, affecting core government services and capital investments. As a result of the Great Recession, most cities recorded declines in their funded ratios from 2009-2015 and were unable to fully recover before the current recession. However, well-funded cities recovered quickly because of their ability to make required contributions consistently even before the Great Recession. In fact, the city of Charlotte, NC, which was more than 90 percent funded in 2009, further improved funding levels from 2009-2015, while cities with substantially underfunded pension plans all reported static or declining funded ratios.[25] The city of San Jose, CA is pre-funding its retirement contributions at the beginning of the fiscal year rather than bi-weekly payments throughout the year.[26]

A few governments are also developing robust cost-sharing mechanisms and benefit design features. This can address market uncertainties, ensure high levels of cost predictability, and help maintain long-term fiscal health. These measures distribute costs and share risks among employers, employees and retirees by "automatically adjusting benefit levels and contribution rates based on actual investment performance or demographic changes."[27] Cost-sharing mechanisms include cost-of-living adjustments that "vary from a plan's funded level, contribution rates that split costs between employers and employees, or alternative plan designs that reduce risk exposure for government employers."

For example, the state of Tennessee implemented a risk-managed hybrid plan in 2013 to keep employer costs stable, including changes to employee contribution rates and benefits. Since the plan's inception in 2013, Tennessee has maintained budget costs and a funded ratio above 90 percent.[28]

As cities grapple with added financial burdens from the current recession, some states are considering municipal participation in their retirement systems. For example, in 2019, nearly 650 local public safety plans in Illinois were consolidated into two statewide funds. Prior to the consolidation, those plans collectively had $11.5 billion in unfunded liabilities with a funded ratio of 55 percent, down from 63 percent prior to the Great Recession.

Illinois' Department of Insurance analysis estimated that these new statewide funds from municipal consolidation could result in investment returns of $820 million to $2.5 billion over the next five years.[29]

Other types of reform measures associated with cost-sharing include making required contributions annually, setting conservative investment return assumptions, and utilizing cost-sharing features to ensure full funding and stable contribution rates.[30]

However, the transfer from a municipality-administered system to a state-administered system should be considered only if the state system is outperforming the city system. In some cases, cities participating in the state system could bear more financial costs and pressure to meet mandatory contribution increases by transferring, as is generally the case with California cities, the majority of which are enrolled in the California Public Employees' Retirement System.[31] Cities like Pasadena could otherwise be responsible for millions more in pension payments, which could mean essential service cuts or government employee layoffs.

Conclusion

State and local governments are still feeling the negative fiscal impact of the Great Recession on their pension systems today, with many continuing to face lower funded ratios and the need to increase employer contributions because long-term investment returns have not matched expectations. The recent market downturn resulting from the COVID-19 pandemic has further exacerbated these trends, and local governments are struggling to both make pension contributions and continue to provide essential services to their residents. Strains on local government finances could make it harder for some cities, towns and villages to pay their required pension contributions in 2021 and beyond. Now is the time for those communities to be asking the right questions of their plan providers, as well as of human resources and finance staff:

- If pension funding has declined in your city, why?
- How have potential changes to actuarial assumptions impacted the funding in your city?
- What is your city's long-term plan to bring its pension funding into alignment with its promises to workers?
- What can be done to keep your city's pension finances on course during the COVID-19 crisis in state and local finance?

Even for the most resilient cities, the pandemic has caused substantial harm that can be repaired only with federal relief. The fiscal challenge of COVID-19-related expenses and revenue shortfalls has deepened since March 2020 in cities across the country, and they need additional aid. Cities need fiscal support to combat the pandemic, provide relief to residents, and keep our communities thriving. Without substantial aid to local governments, municipalities may radically reduce services or even declare bankruptcy or default on their financial obligations.

Endnotes

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