Bloomberg Law

Professional Perspective

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Public pension systems in the United States are under pressure. Investment returns are in doubt, and the state and local governments that provide significant funding for benefits are facing historic budget shortfalls. We have seen these challenges before – as recently as 2009. Though how public pension systems will address the economic impacts of the Covid-19 pandemic, and what repercussions will confront beneficiaries, investment firms, and pension fund creditors, largely remains to be seen.

The Relationship Between Governments and Their Pension Systems

The legal and financial relationship between state and local governments and their public pension systems is complex and varied, in some ways independent of one another yet also inter-dependent. We can appreciate the magnitude of the risks facing pension systems from the Covid-19 recession if we understand their dependence on state and local governments.

The legal relationship is defined by state law. In many cases the pension system is constituted as a separate legal entity, while in other cases it is merely a segregated fund of the government itself. The enforceability of a pension system's obligations to pensioners and creditors against either the system itself or the government, including whether claims could be barred because of sovereign immunity, depends on state law.

In practice, public pension systems often behave like commercial actors. While the government employer must make regular employer contributions to the system, accumulated assets are segregated from the general assets of the government—even when a state or municipal treasurer serves as the custodian. Those assets are invested, and the return on investment is an important source for pension benefit payments. Pension systems do not receive direct tax revenues, and they sit on approximately $4 trillion in publicly-traded securities, private equity investments, real estate, and other assets.

But despite significant accumulated assets, public pension systems generally fund a large majority of their annual benefit payments from the periodic employer contributions that they receive from state and local governments. Those governments are facing unprecedented budget shortfalls, such as California's projected $54 billion annual budget deficit. The Center on Budget and Policy Priorities, a progressive think tank, projects an aggregate state budget shortfall of $555 billion over three years (fiscal years 2020-2022). As state and local governments search for solutions to their immediate fiscal needs, pension systems are concerned about the repercussions of those budget decisions.

Pension Holidays

Pension holidays—when an employer skips or reduces a pension contribution payment--are an imminent threat of Covid-19. Some state and local governments may be tempted to reduce short-term employer contributions to their pension systems as a way to reduce their budget deficits, just as many did during the last government fiscal crisis in 2009.

The impact of pension holidays lingers long after normal contributions are restored. The lost investment return on those contributions compounds the financial impact. The Center for Retirement Research at Boston College estimates that the average funded ratio for U.S. public pension systems fell from 87% in 2008 to 71% in 2019, despite significant investment returns over that period. Take Illinois as one extreme example: the state's Commission on Government Forecasting and Accountability calculated that pension holidays and other skipped or reduced employer contributions were the single largest reason for the state's $137 billion unfunded pension liability, accounting for $54 billion in lost funding over 25 years.

More immediately, pension holidays present a liquidity challenge to pension systems trustees and managers. The hope is that many systems have sufficient cash-on-hand and liquid assets to fund short-term benefit payments without needing to liquidate their long-term investments. But faced with missed, reduced, or delayed employer contribution payments, some pension systems may be forced to tap their long-term assets to meet short-term payment obligations.

Reduced Investment Return Assumptions

Pension systems will also need to re-examine their assumed investment returns. Pension trustees have a fiduciary responsibility to set assumed investment returns based on the best current analysis, even as that analysis changes in response to extraordinary events like Covid-19.

While market investment returns have rebounded since their March 2020 lows, investment returns may still suffer materially, and the future may be more volatile and less lucrative. Even before Covid-19, many pension systems had reduced their assumed rates of return on invested assets. According to a recent report by the Pew Charitable Trusts, the median assumed rate of return used by state retirement system was reduced from 8.0% in 2010 to 7.5% in 2016.

Further reductions would put additional strain on state and local government employers' budgets. Lowering the assumed rate of return increases the employer contribution required to maintain a pension system's funded ratio. The Pew Charitable Trusts estimates that a one-percentage point reduction in the rate of return would increase unfunded liabilities of state retirement plans by $500 billion, creating a further gap to be filled by additional employer contributions.

Risks to Investment Firms, Creditors, and Beneficiaries

As pension systems consider how to navigate possible pension holidays and uncertain investment returns, what risks are confronting those who rely financially on pension systems: the pensioners that receive benefit payments, the investment firms that manage pension assets, and the creditors who lend to both pension systems and those investment firms?

The added fiscal stress might not be immediately felt. The average public pension system, with a 71% funded ratio, likely has assets sufficient to cover payments for a decade or longer without taking in new employer contributions. Even pension systems with low funded ratios may have significant assets at their disposal for the payment of immediate liabilities—albeit at further risk to their funded ratios and longer-term fiscal health.

Weakening balance sheets will also impact pension systems' ability to invest in certain categories of assets. State laws and pension system investment policies often require systems to maintain sufficient liquidity to fund short-term benefit payments, as well as cap the maximum portion of assets that can be invested in private equity and other alternative investments with reduced liquidity. If a pension system's assets diminish—whether because of pension holidays or reduced investment returns—that system may need to reallocate its investment portfolio to increase liquidity and reduce the overall level of risk in its portfolio.

If pension system assets are depleted, most states still legally protect benefit payments to pensioners. The specific legal theory of protection depends on state law. For example, benefits are constitutionally guaranteed in seven states, including Illinois and New York, while most other states hold that pension benefits are enforceable contract or property rights. Only Indiana and Texas treat pension benefits as a gratuity that can be changed at any time. Thus in most cases, a public pension system's payment obligation to beneficiaries is legal protected and may even be enforceable against its related state or local government.

Impact of Federal Bankruptcy

In perhaps a worst case scenario, what impact would pension system beneficiaries and creditors experience from a municipal bankruptcy or restructuring coming out of the current Covid-19 crisis?

Federal law does not permit state governments to declare bankruptcy or restructure under the U.S. Bankruptcy Code. Municipalities and other local governments may restructure under Chapter 9 of that code only if authorized under state law. To date, 22 states have granted authorization in some form, but in many cases those states impose additional limitations or pre-conditions on bankruptcy filings or require the municipality to obtain further approvals from state officials. Major municipal bankruptcies remain very rare, with the well-known exception of the 2013 Detroit bankruptcy.

While pension benefits are largely legally protected under state law, the federal court overseeing the Detroit bankruptcy held that pension benefits could be reduced under federal law. The City of Detroit was able to cut $7.8 billion in pension benefits and $4.3 billion in health care benefits for retirees, alongside other municipal debt.

It is untested whether a municipal pension system itself could file under Chapter 9, separate and apart from the municipality it serves. Many municipal pension systems are not constituted as separate legal entities, calling into question whether they are sufficiently distinct instrumentalities of government to file independently. Other municipal pension systems are commingled with state pension systems, which poses its own jurisdictional challenge under Chapter 9. Additionally, because pension benefit payments are often also protected by state law, such a filing may not have the intended effect of reducing long-term liabilities: pensioners would still try to look to the state or municipality, which would not benefit from the protections afforded to the debtor.

A Rocky Road Ahead

Many state and local governments face difficult choices ahead to balance budgets. Some may consider changes to their current employer contributions, which would put further strain on pension systems, particularly those that came into this crisis already underfunded. While those pension systems—even underfunded ones—have assets on-hand to cover short-term obligations, beneficiaries and creditors should pay close attention to the impact of funding decisions in the years ahead. The effects will be felt long after the pandemic subsides.