Business Report

A growing problem

MIND GAMES: PAR President Jim Brandt calls it "mind boggling" that no thought was given to early payment of the retirement debt despite a state surplus the past few years.

By Stephanie Riegel (Contact)

Tuesday, November 20, 2007

When Gov.-elect Bobby Jindal takes office early next year, one of the most significant financial issues he'll face is something most people have never even heard of, much less given any thought to. It's a massive and growing hole in the budget that funds the four major state retirement systems.

To help fill it will cost nearly $700 million next year, an estimated $875 million by the end of Jindal's first term and more than $2.2 billion 20 years from now, which is when state law requires that it be completely paid off.

You might think a looming debt like this—it was most recently estimated at more than $11 billion and growing—would sound alarm bells somewhere. But the state's Unfunded Accrued Liability (UAL), as this debt is officially termed, can't seem to gain any traction as an issue

from even those who should care most about it—the nearly quarter of a million members of the four major state retirement systems.

"It's not on the forefront of anybody's mind," laments veteran Sen. Butch Gautreaux, D-Morgan City, who as chairman of the Senate Retirement Committee is one of the few who actually does worry about the UAL. "Even those who are in the system don't come to Baton Rouge to voice their concerns."

They should. Even though the state has a constitutionally mandated plan to pay off the UAL, that plan is in trouble. A back-ended payment schedule, overly generous benefits added over the years by lawmakers looking to curry favor with special interest groups, investment losses and smaller state payrolls have combined to increase the difference between what the pension funds have and what they need to be fully funded.

While it's unlikely the systems will be unable to meet their obligations to future retirees—unless the state goes bankrupt—there's a bigger issue at stake: The state is willfully ignoring a growing debt at the expense of the future generations that will be forced to pay if off.

What's maddening is that it doesn't have to be this way. The state has finished the past two fiscal years with a budget surplus—a big one, as a matter of fact. Any $1 used to pay off part of the UAL today would save $4.36 in future budgets. Yet lawmakers have not dedicated a single penny of the surplus to the retirement systems' debt.

"Given that the state has had so much surplus money over the past couple of years, it's mind boggling that there was no thought given to early payment of the retirement debt," says Jim Brandt, president of the Public Affairs Research Council (PAR).

Actually, it's not all that mind boggling when you consider the history of the retirement systems; they've been in debt since they were created decades ago. The two largest systems that cover three-quarters of all state employees—the Teachers' State Retirement System of Louisiana (TRSL) and the Louisiana State Employees' Retirement System (LASERS)—were established in 1936 and 1946, respectively, and from day one both were underfunded. That's because existing employees were grandfathered in and guaranteed a pension upon retirement, even though they had never contributed a portion of their earnings.

It might have been good politics, but it wasn't good business and it set a precedent that fit well with the state's laissez faire practice of putting off till tomorrow what it can't pay for today. The debt grew larger over the years, as legislators generously added benefits for one favored group of employees or another—without ever identifying a funding source. In the mid-1980s, legislators realized they had to do something and proposed a constitutional amendment that voters passed in 1987. It requires that the state's retirement systems be fully funded—but not until 2028, which at the time was 40 years away.

Though a step in the right direction, the payment schedule created as a result of the amendment was the equivalent of an interest-only mortgage. For years, the state had only to scrounge up a relative pittance in interest-only payments. In 1989, the payment was less than $100 million. Last year, as the debt topped $11 billion, the payment was up to nearly $600 million. Still, nothing even goes toward the principal until 2015, when the required payment hits around $900 million. By 2018, it will top $1.25 billion. It will peak in 2029 at $2.2 billion.

Veteran lawmakers recall the discussions that surrounded the decision to back-end the payment schedule. They all knew it wasn't a particularly smart thing to do, but with so many other pressing needs, it was easier to put off the hard spending decisions until later.

"We were always struggling to find funds for education and health care," says Rep. John Alario, D-Westwego. "Politically it just seemed to make more sense to put money toward

things like health care and education than to exercise discipline and pare down some of the debt on the retirement system."

In 1992, the Legislature tried to inject a little more sense into the payment schedule by amortizing the payments so that they would increase annually by a steady 4.5%. That helped, but the figure was based on the assumption that the state's payroll would increase by that amount each year. It hasn't, averaging a little more than 3% growth over the past decade, thanks in part to a big decrease following hurricanes Katrina and Rita. That means the employee contribution rate hasn't measured up to projections.

"If your payroll is growing at 4.5% and your payments are increasing at that rate then you're even," says Charles Hall, a consulting actuary for LASERS and TRSL. "That hasn't happened."

Louisiana isn't unique in this respect. Many states are grappling with a similar problem, as are the federal government and many large corporations. But Louisiana's funding levels are particularly low. Nearly 60% of state pension plans are funded at 80% or higher, according to the National Association of State Retirement Administrators. Louisiana's systems are funded at just 65% on average, which makes the state the fifth worst in the nation in terms of its retirement funding.

"I don't know of any state that is fully 100% funded," PAR's Brandt says. "But we have one of the lowest funding levels of all, so it's pretty serious."

How serious? That depends on the state's long-term financial viability. Since the state constitution guarantees that payments be made to the funds, there's not much chance that retirees of the present or future will get gypped of their benefits any time soon. That would only happen if the state were bankrupt.

But it's bad business for the state to have so much debt on its books, and it's about to get even more. A recent ruling by the Governmental Accounting Standards Board (GASB) requires that states report all of their unfunded liabilities when drawing up their budgets. In Louisiana's case, that means an additional debt of between $6 billion and $9 billion in unfunded health benefits to state workers will now be recorded in red on the balance sheet, which will bring the state's total unfunded liability to somewhere around $20 billion.

When tens of billions in liabilities show up on the ledger, the states' financial picture won't look so good, according to State Treasurer John Kennedy. Especially when no one's bothering to do anything about it.

"This is a responsibility and a promise the state has made to its employees," Kennedy says. "We can't just stick the next generation with the tab for it."

Officials at the major retirement systems say they're concerned about the problem and are always trying to find solutions. Without much legislative support, however, that's easier said than done.

"We can try to make the Legislature and the administration aware of the problem and we do," says Cynthia Rougeou, executive director of LASERS. "But legally we cannot lobby, so we can only do so much."

One thing the systems have done in recent years is to invest more aggressively, diversifying outside of traditional equities into riskier funds that carry higher rates of returns. Not that they had much choice; the Legislature several years ago set the assumed rate of return for LASERS and TRSL at 8.25%, which is higher than what most states assume they'll make on their investments. Some say the change was just a budget-balancing gimmick. LASERS officials say it's a reasonable assumption.

“We think it’s a fair number,” says Bobby Beale, chief investment officer at LASERS. “Most states assume somewhere between 7.5% and 8.5%, so we’re right in the middle.”

Still, it puts the systems under pressure to hit their targets, which hasn’t always happened in recent years with wild market fluctuations. It has also prompted the two largest systems to hire more outside money managers and advisers. In TRSL’s case, 98% of the system’s assets are under outside management, while nearly 15% of its assets are in alternative investments, which is an unusually high percentage according to PAR.

LASERS, on the other hand, recently moved more of its investments in-house. More than 30% of its investments are internally managed and only 5% are in alternative investments.

“We have a good group of very qualified people up here,” Beale says. “That allows me to run some of that money in-house and save in the long run.”

Beale says investment decisions are based on the assumed rate of return, which LASERS exceeded last year with earnings of more than 9%, not on the size of the unfunded liability.

“Having a huge UAL doesn’t encourage me to make riskier investments,” he says.

There are other solutions to paring down the UAL, but they are politically unpopular. The most obvious is to devote extra money to help whittle away at the debt. It makes sense, especially given the $1 billion-plus surplus the state had at the end of last year.

Gov. Kathleen Blanco tried in a special session last December to devote $200 million in surplus funds to the UAL. At the time, it would have resulted in a future savings of more than $1 billion, but legislators found other uses for the money.

“That would have put us a full year ahead of schedule,” says Jim Baronet, a spokesman in the Division of Administration. “For whatever reason, it didn’t pass, but we feel like we showed our commitment to paying down the UAL.”

Gautreaux, the head of the Senate Retirement Committee, was also disappointed more lawmakers didn’t see the wisdom of spending some surplus on the UAL.

“When those committees see that money, it just gets scalped,” he says. “I’ve tried to argue that we have a fiduciary responsibility, but it falls on deaf ears.”

Jindal favors using some of the budget surplus he will happily inherit to reduce the state’s UAL. But he can’t say yet exactly how much should go to the retirement system debt when there are so many other one-time expenditures in desperate need of money.

“We should be looking at that surplus for one-time expenditures like the unfunded liability and also for capital expenditures like roads and coastal restoration,” he says.

While paying off some of the debt ahead of time is the optimum solution—and appears to be more of a possibility this year than last—another potential solution is to take the opposite tack. The state could extend the payment schedule over a longer period of time, essentially the equivalent of refinancing a home loan.

But Rougeou doesn’t support that idea. Neither does Kennedy, who points out that it would burden the state with still more debt while merely putting off the inevitable for a few more years.

“Look, the time to fix the roof is when the sun is shining,” says Kennedy. “The sun is shining right now. To even think about re-amortizing your payment schedule is crazy because it just means you’re going to have to pay more interest in the long run.”

Which leaves a third option—keeping the payment schedule as it is but exercising more financial prudence to make sure the debt doesn’t get any bigger. A state constitutional amendment approved by voters in last month’s election will help. It requires the Legislature to identify a funding source before adding any new beneficiaries to the retirement systems. It’s but one step of several the state can and should be taking to keep the UAL under control, according to those who closely monitor the situation.

“At least we know we’re not going to be making things any worse,” Gautreaux says. “But I would like to see us put together a strategic plan to address this. It’s one of the things I’ve talked about in the Legislature but it never seems to get done.”