The New York Times
nytimes.com

PRINTER-FRIENDLY FORMAT
SPONSORED BY
IN AMERICA
SELECT THEATRES
NOVEMBER 26

October 12, 2003

States Risk Bigger Losses to Fund Pensions

By MARY WILLIAMS WALSH

Many state and local governments, facing ballooning pension promises to police officers, firefighters, teachers and other public employees, are rushing to sell bonds to cover the shortfall. That strategy has sometimes backfired in recent years, leaving taxpayers on the hook for even more debt.

States and municipalities are drawn to bond sales because they bring instant cash, easing budget pressures without further tax increases or reductions in retirement benefits.

But critics say the bonds could prove costly for some officials using them — and for the local taxpayers. The cities and states have to pay a fixed rate of interest on the bonds, and are essentially betting they can earn a higher rate of return by investing the proceeds in their pension funds.

But recent investment losses have already left some cities and states on the hook for a mounting debt, covering not just the retirement money for their workers but also the interest on the bonds. New Orleans, Pittsburgh and New Jersey have all placed losing bets in recent years.

Almost all pension funds have suffered sizable losses over the last three years. Government pension plans can dig themselves into deeper holes because, unlike corporate pension plans, they are not bound by federal requirements to maintain a certain level of funding. Some have no reserves at all: they just pay as they go, out of revenues.

With money tight, municipalities are desperately looking for financial help. This year, pension bonds will account

for nearly 5 percent of all new municipal bonds, up from less than 1 percent in each of the last five years.

In the first nine months of this year, Illinois, Oregon's school boards, New Jersey's economic development authority and more than a dozen towns and counties sold $13.3 billion in bonds for pension purposes, almost as much as the total sold for pensions throughout the 1990's, according to Thomson Financial, a research firm.

More sales are coming. Wisconsin and Oregon each plan one before the end of this year, and Kansas has authorized a sale. West Virginia, home of the nation's weakest public pension plan — according to a study by Wilshire Associates, an investment advisory firm in Santa Monica, Calif., the state teacher's plan has only $1 for every $5 it owes — is fighting a court battle to sell $3.9 billion of the bonds without first holding a referendum. In California, a planned $1.9 billion bond sale for state employees' pensions contributed to the fiscal uproar that led to the recall of Gov. Gray Davis.

Other officials have weighed the risk and declined. "It's really tough to justify," said Robert C. North, the chief actuary for New York City's five employee pension plans. For years, Mr. North said, investment bankers have been urging the city to sell bonds to pay for its pension promises, and every time, he argues against it because he believes there are sounder and cheaper ways of financing pensions.

"On a risk-adjusted basis, the only people who can make money on this are the investment bankers," Mr. North said.

This risk is not always made sufficiently clear, critics say, by financial consultants who stand to make money from the bond sales.

New Orleans recently found out just how deep a hole it had dug for itself by selling bonds in late 2000 to finance the pensions of 820 retired firefighters. In May, city officials asked the manager of the bond sale, UBS Financial Services, for a progress report and were shocked to learn that the deal was expected to cost the city $270 million over time.

"We were thinking that we were going to make money on it," said Suzy Mague, fiscal officer for the New Orleans city council.

City officials say their rosy expectations were created by PaineWebber, the lead underwriter, when it described the bond transaction. (PaineWebber, which collected a $3 million fee for its role in the bond sale, has since merged with UBS.)

"It was basically presented to us as, `Look, this is really the way to go. Even if you use the worst estimates, you still break even,' " said Scott Shea, a former city council member who served on the budget committee at the time.

According to Ms. Mague, PaineWebber said New Orleans would probably have to pay about 8.2 percent interest on the bonds. PaineWebber predicted that the city could expect to earn 10.7 percent a year, on average, by investing the proceeds, mostly in stocks, a prediction based on returns from 1983 to 1999 — a period that encompassed the greatest bull market in history.

A spokeswoman for UBS said the company did include less favorable possibilities in its presentation, and did not suggest that 10.7 percent, or any other rate of return, was guaranteed.

Mr. Shea said he asked PaineWebber about risk. "I frankly don't recall anybody telling me, `Look, if the market tanks, you'll be in worse shape than if you had never sold the bonds,' " he said.

New Orleans issued bonds worth $171 million in December 2000, and almost immediately, the stock market tanked. Instead of returning 10.7 percent a year, the investments have suffered losses of about 3 percent a year.

By June, only $98 million was left — enough to pay the firefighters' pensions for just a few more years. When the money runs out, the city will still have to pay their pensions — about $17 million a year — but then it will also have to pay interest on the bonds of $16 million a year.

Pittsburgh, likewise, sold $294 million of bonds in 1996 and 1998 to buttress a skimpy pension plan for its workers. Before that, the city was spending about $21 million a year from its operating budget to keep the plan afloat.

After an initial spurt, the pension plan slumped again when stock prices fell. Today, Pittsburgh is paying $26 million a year to shore up the plan and to pay its bondholders. Two major credit-rating agencies recently said they were reviewing Pittsburgh and might lower its rating because of its heavy indebtedness.

New Jersey had similar results after issuing $2.8 billion of bonds in 1997. The sale was the largest of its kind then and made headlines by generating $53 million in fees for various securities and law firms.

In the first two years, the transaction looked good. New Jersey earned more than double the break-even amount. Then the markets turned. As of June, the pension plan's five-year average return was 1.9 percent, nowhere near enough to cover the pension costs and bond interest, which this year totaled $890 million.

"This money didn't build a road or a bridge, but we still have to pay it," John E. McCormac, the state treasurer of New Jersey said.

Officials may look past unhappy outcomes like these in part because market conditions have improved. Stocks are rising. Interest rates are very low, and officials see an opportunity to lock in debt at historically attractive rates.

Even Orange County in California is considering an issue, despite lingering concerns over its bankruptcy proceedings in 1994.

The county got into trouble after taking on undue investment risk, something critics of the new issues fear will happen again as states reach for higher returns. New Jersey, for example, has restricted pension investments to stocks and bonds, but is reviewing its portfolio and whether to hire an independent money manager, as other states do.

The state's auditor has recommended investing a small amount in alternative investments, perhaps real estate, venture capital or other instruments that may provide greater returns, at greater risk.. Some state employees oppose the change, saying the risks are too great.

Their view is supported by some government finance specialists and academics, who argue that speculative investments, even stocks, are unsuitable in pension funds. They say that people retire on predictable schedules, and it is safest to invest conservatively, in bonds that will mature when people need the money.

Depending on market conditions, though, the current crop of bonds could pay off handsomely for the governments issuing them.

An Illinois official says that the state's $10 billion bond issue was based on an assumption that the money would earn 8 percent to 8.5 percent annually. Illinois will pay 5.07 percent interest on the bonds. "As long as the actuaries are right," said a spokeswoman for the state budget bureau, "we should be safe."