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Public Pension Plans Face Billions in Shortages

By [MARY WILLIAMS WALSH](#)

In 2003, a whistle-blower forced San Diego to reveal that it had been shortchanging its city workers' pension fund for years, setting off a wave of lawsuits, investigations and eventually criminal indictments.

The mayor ended up resigning under a cloud. With the city's books a shambles, San Diego remains barred from raising money by selling bonds. Cut off from a vital source of cash, it has fallen behind on its maintenance of streets, storm drains and public buildings. Potholes are proliferating and beaches are closed because of sewage spills.

Retirees are still being paid, but a portion of their benefits is in doubt because of continuing legal challenges. And the city, which is scheduled to receive a report today on the causes of its current predicament, still has to figure out how to close the \$1.4 billion shortfall in its pension fund.

Maybe someone should be paying closer attention in New Jersey. And in Illinois. Not to mention Colorado and several other states and local governments.

Across the nation, a number of states, counties and municipalities have engaged in many of the same maneuvers with their pension funds that San Diego did, but without the crippling scandal — at least not yet.

It is hard to know the extent of the problems, because there is no central regulator to gather data on public plans. Nor is the accounting for government pension plans uniform, so comparing one with another can be unreliable.

But by one estimate, state and local governments owe their current and future retirees roughly \$375 billion more than they have committed to their pension funds.

And that may well understate the gap: Barclays Global Investments has calculated that if America's state pension plans were required to use the same methods as corporations, the total value of the benefits they have promised would grow 22 percent, to \$2.5 trillion. Only \$1.7 trillion has been set aside to pay those

benefits.

Not all of that shortfall, of course, is a result of actions like those that brought San Diego to its knees. And few governments have been as reckless as San Diego officials in granting pension increases at the same time as they were cutting back on contributions.

Still, officials in Trenton have been shortchanging New Jersey's pension fund for years, much as San Diego did. From 1998 to 2005, the state overrode its actuary's instructions to put a total of \$652 million into the fund for state employees. Instead, it provided a little less than \$1 million. Funds for judges, teachers, police officers and other workers got less, too.

To make up the missing money, New Jersey officials tried an approach similar to one used in San Diego. They said they would capture the "excess" gains they expected the pension funds' investments to make and use them as contributions.

It was a doomed approach, leaving New Jersey to struggle with a total pension shortfall that has ballooned to \$18 billion. Its actuary has recommended a contribution of \$1.8 billion for the coming year, but the state has found only \$1.1 billion, so it will fall even farther behind.

Illinois also duplicated one of San Diego's pension mistakes. It tried to make its municipal pension plan cheaper by stretching its funding schedule over 40 years — considerably longer than the 30 years that governmental accounting and actuarial standards permit, and more than five times what companies will get under a pension bill that has just passed Congress.

Illinois is stretching its pension contributions over 50 years. At that rate, many of its retirees will have died by the time the state finishes tapping taxpayers for their benefits.

Colorado does not meet the 30-year funding guidelines, either. "At the current contribution level, the liability associated with current benefits will never be fully paid," the state said in its most recent annual financial report.

Many officials dispute the suggestion that their pension plans are less than sound. The director of the New Jersey Division of Pensions and Benefits, Frederick J. Beaver, wrote recently that "our benefits systems are in excellent financial condition."

Illinois officials say the state's 50-year schedule is actually an improvement; before adopting it in 1995, the state had no funding schedule at all. In Colorado's most recent legislative session, lawmakers enacted pension changes that they hope will make the plan solvent in 45 years.

And the National Association of State Retirement Administrators says it is unrealistic to expect all public plans to be fully funded, because they do not have to pay all the benefits they owe at once.

Still, the lack of a national response to what would seem to be a nationwide problem underscores a peculiarity of the public pension world: like banks and insurance companies, the pension plans are large and complex financial institutions, but they face no comparable systems of checks and balances.

“There’s no oversight; there’s no requirements; there’s no enforcement,” said Lance Weiss, an actuary with Deloitte Consulting in Chicago who advised Illinois on its pension problems. “You’re kind of working off the good will of these public entities.”

Experts do not think that is good enough.

In January, the board that writes the accounting rules for governments announced that it was looking for ways to tighten the rules for public pensions.

In July, Senators [Charles E. Grassley](#) and [Max Baucus](#), the Republican chairman and the ranking Democrat on the Finance Committee, asked the Government Accountability Office to investigate the financial condition of the nation’s public pension plans.

In some states, lawmakers have been trying to stop some of the more egregious pension practices that have come to light. Illinois, Louisiana and Nebraska passed laws making it hard for employees to “spike” pensions higher by manipulating their salaries. Because pensions are often based on a worker’s final salary, workers have found ways to credit one-time bonuses to their last year and reap a lifelong reward. Arizona required that early retirement programs be paid for up front.

And today in San Diego, a former chairman of the Securities and Exchange Commission, [Arthur Levitt Jr.](#), is scheduled to issue a long-awaited report on the years of pension lapses that got the city into its current predicament.

Mr. Levitt is not tipping his hand on his findings. But given the activist stance he took on cleaning up the municipal securities markets as S.E.C. chairman, it would be no surprise if he called for tighter control over a sector where the amounts of money are huge and the amount of oversight is small.

The city of San Diego hired Mr. Levitt’s three-man audit team in February 2005, after the city’s outside auditor, KPMG, would not sign off on its accounts.

He is working with the S.E.C.’s former chief accountant, Lynn E. Turner, and Troy Dahlberg, a managing director in the forensic accounting and litigation consulting practice of Kroll Inc., the investigative firm that is a unit of [Marsh & McLennan Companies](#).

Public plans are not governed by the federal pension law, the Employee Retirement Income Security Act, that companies must follow. They are not covered by the Pension Benefit [Guaranty Corporation](#), so if they come up short, they must turn to the taxpayers.

Instead, they are governed by boards that often include municipal labor leaders, whose duty to represent their workers' interests can easily conflict with their fiduciary duty to represent the plan itself. And even the most exemplary pension boards can be overruled, in many cases, by politicians whose priorities may be incompatible with sound financial management.

“When the state runs into financial trouble, pension contributions are something that they can defer without, quote-unquote, hurting anybody,” said David Driscoll, an actuary with Buck Consultants who recently helped Vermont come up with a plan to revive its pension fund for teachers. Politicians shortchanged it every year for more than a decade.

“In fact, they are hurting people, and the people they are hurting are the taxpayers, who, whether they realize it or not, are going into a form of debt,” Mr. Driscoll added. “Those pension obligations don't get cheaper over time. They get more expensive.”

Eventually the cost gets too big to ignore, as it now has in New Jersey.

Corporate pension funds have plenty of problems of their own. But they are at least required to adhere to a uniform accounting standard, which provides information that investors can use to decide upon stocks to buy and sell. The standards, in turn, are policed by the S.E.C.

Taxpayers have no such help. For municipal plans, the accounting standards are much more flexible, a decision that was denounced, when it was issued in 1994, by the head of the very board that wrote it.

James F. Antonio, chairman at that time of the Governmental Accounting Standards Board, attached a detailed 10-page dissent to the new rule, saying that it “fails to meet the test of fiscal responsibility” because it permitted “an extraordinary number of accounting options” and some governments were bound to choose the weakest one. Mr. Antonio has since retired.

Even though the governmental accounting board has now begun the slow process of improving the standard, it is unlikely to come up with the level of detailed disclosure required of corporations. And the board, with a full-time staff of just 15, has no authority to enforce its rules.

San Diego violated the rules for a number of years, using accounting techniques that hid both its failure to put enough money behind its pension promises and the debt to its workers that was growing every year as a result.

Several times, the city asked the government accounting board to make a special exception and approve its unorthodox pension calculations, but the board rebuffed it.

But the accounting board was forced to look on in silence as San Diego issued reassuring financial statements, because its charter bars it from issuing public pronouncements on individual cities.

San Diego might have gone on unchallenged indefinitely if not for the decision of one of its pension trustees, Diann Shipione, to blow the whistle, eventually forcing the city to correct the financial disclosures it had made in connection with an impending bond sale. Only then was it possible to see in one place what had been going on with the pension fund. And only then did the S.E.C. get involved.

The Depression-era laws that created the commission gave it no direct jurisdiction over municipal securities; it can pursue municipal wrongdoing only when it finds fraud at work. Lack of complete and accurate disclosure can constitute fraud, but the S.E.C. has only infrequently shown interest in throwing its weight around in the area.

One of those rare instances happened when Mr. Levitt was chairman of the S.E.C., in 1994, after Orange County, Calif., abruptly declared bankruptcy and threatened to repudiate its debts. Mr. Levitt became, as he said at the time, “obsessed” with cleaning up the municipal securities markets.

He created an independent Office of Municipal Securities that reported directly to the chairman; he championed rules to eliminate the pay-to-play practices then commonplace in the municipal bond business; he forced better financial disclosure; and he began an unheard-of number of enforcement actions.

Since Mr. Levitt’s departure from the S.E.C. in 2001, much of what he built has been dismantled. The Office of Municipal Securities is down to a staff of two and is no longer independent. The wave of enforcement actions against cities has slowed to a trickle. The S.E.C. investigators who went to work in San Diego after the pension scandal erupted have never said what they found.

When the S.E.C. shifted its gaze away from municipal finance, Mr. Levitt now says, it left “a regulatory hole.” If the agency were equipped to monitor state and local governments the way it monitors corporate disclosures, he said, “it could provide an early warning of financial conditions threatening the solvency of any number of communities.”

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Costly Promises

New York Gets Sobering Look at Its Pensions

By [MARY WILLIAMS WALSH](#) and [MICHAEL COOPER](#)

Every year since 1999, New York City has reported that it has all the money it needs to pay for the pensions that have been promised to city workers.

With the retirement plans said to be financially sound, state politicians have happily showered city employees with generous pension enhancements — annual cost-of-living increases, holiday bonus payments, early retirement with full benefits — that are the envy of private-sector workers, whose pension benefits have eroded.

But a close inspection of city pension records shows that the funds committed to the plans may fall well short of the city's promises to hundreds of thousands of current and retired workers. They look fully funded chiefly because the city has been using an unusual pension calculation that does not comply with accepted government accounting rules. Even the city's chief actuary, who helps produce the annual reports, says the official numbers are "meaningless" when it comes to showing the plans' financial health.

The chief actuary, Robert C. North, has prepared a little-noticed set of alternative calculations showing that the gap in the pension funds could be as wide as \$49 billion. That is nearly the size of the city's entire annual budget and the equivalent of the city's publicly disclosed outstanding debt.

The existence of a big gap between the city's future obligations and the resources committed to meet them does not mean the pension funds are about to run out of money. But it does mean that New York City is promising its current employees future benefits it might not be able to provide without big tax increases or major budget cuts. When such a reckoning might occur, if at all, is hard to predict.

Pensions are now one of the city's fastest-growing expenses. In recent years the city's required contributions to its pension funds have more than quadrupled, to \$4.7 billion this year from \$1.1 billion in 2001.

Two years from now, the city expects to spend one out of ten dollars in its budget on pension contributions.

Senior city officials vehemently dispute the suggestion that their pension funds are weaker than the official numbers claim and point out they are contributing more money to them every year. But a number of outside experts said the city's accounting method was flawed because it provides a misleading portrait of the plans' real condition.

In New York, public workers' pensions are guaranteed by the State Constitution, so once they are granted, they cannot be reduced, even if they cost more than expected.

Many economists say government pension accounting routinely understates the cost of benefits promised to state and local workers, because the rules allow the plans to take credit for investment gains not yet achieved. But there is no agreement on whether the rules should be changed and if so, what the new method should be.

Mr. North said he believed that if there were a uniform standard among cities, the health of New York's plan would be about average.

Mr. North, the city's chief actuary since 1990, is well regarded in his field and has been a visible participant in the debate over whether actuarial methods have themselves contributed to the weakness of both public and private-sector pension funds. He said that he decided to recalculate the city's five pension funds because the official numbers were so uninformative.

"You're getting no new information," he said, even as the value of investments in the funds change.

He said he came up with the \$49 billion gap by using a very conservative method, based on the use of risk-free investments, not stocks, similar to the way life insurance companies calculate the premiums for products that are comparable to pensions.

Mr. North acknowledged that other governments did not use this method and other analysts might call for a less stringent approach, which would make the shortfall look smaller. But aside from that broader debate over how to credit investment gains, experts who looked at the city's official pension reports also said the reassuring numbers shown there were incorrect.

"It makes me shudder," said Penny Wardlow, a government accounting specialist who served as a consultant to the Governmental Accounting Standards Board, an independent body of experts, when it drafted its pension rules in 1994.

She said New York City's unusual way of reporting its pension values did not comply with the rules, because it artificially pegged each plan's shortfall at zero, or close to it. This could easily mislead public officials into thinking the pension funds are healthier than they really are, she said.

New York City adopted the new method with the best of intentions in 1999, during a robust economy, as a tool to encourage officials to put enough money aside to pay for future pensions, even at times when it might appear that the fund had a surplus.

But no other large city or state plan uses this method, which is not among the six that accounting rule-makers have authorized for municipalities to rely on when reporting the status of their pension funds. And it has failed at its goal: for the last five years, lawmakers have repeatedly postponed committing the full amount of money necessary to keep up with the rise in benefits.

Differing Views

Senior New York City officials bristled at the suggestion that their annual reports were flawed and strongly disagreed with any suggestion that the pension plans might be under-funded.

“The city’s pension funds are 99.6 percent funded by acceptable methods for evaluating and disclosing pension fund assets and liabilities,” said Martha Stark, the New York City finance commissioner. “While there are other methods for determining funded status that are being discussed, those methods are academic at this time.”

Ms. Stark said that she was sure of the pension funds’ health because the city was contributing responsibly to them every year, and because she was confident that the investments in the funds would meet their targets of 8 percent average annual returns over the long haul. Many other public plans have investments targets in this range.

She said that there were many ways to measure the health of the pension funds, and that while one method may show a large hidden shortfall, another would show that at least one of the plans had a slight surplus. She contended that no one method was better than another for all purposes.

Asked why the pension funds appeared to be fully funded back in 1999, when they were swollen with gains from the stock market boom, and still appear to be almost fully funded now — after losing billions of dollars in the stock market and granting billions of dollars worth of new benefits — she said that the numbers were “smoothed” to avoid short-term fluctuations. She also noted that the city had been increasing its annual contributions in recent years.

The independent governmental accounting board, which sets standards for state and local jurisdictions across the country, is not allowed to comment publicly on New York City’s financial statements.

“But I can tell you that our standard is very clear on this issue,” said Gerard Carney, a spokesman for the board, “and we fully expect it to be followed accurately. Moreover, history has shown that bad things can happen when accounting standards are not accurately followed.”

Unlike the accounting board for companies, however, the governmental accounting board has no enforcement agency backing it up. A company that breaks an accounting rule may hear from the Securities and Exchange Commission; a government will not. The rules board relies on each local government's outside auditor to police violations.

New York City's outside auditors defended its unusual accounting approach.

Robert Rooney, an audit director at Deloitte & Touche who worked on New York City's audit, said he was not permitted to discuss the details of New York City's financial reports because of confidentiality rules. But in general, he said, it was possible to modify accounting standards without violating them.

When Deloitte's auditors see such a modification in a city's financial report, he said, they discuss it with the city's officials to make sure they understand it. If the modification is not material or misleading, he said, then the city can use it and still get a clean audit.

New York City's comptroller, [William C. Thompson Jr.](#), who has ultimate responsibility for the city's financial statements, said through his spokeswoman that he believed New York was compliant with the accounting rules. He also said that pension calculations were "the subject of much debate."

"We will continue to work with the boards of our pension funds and the actuary to assess the funded status of the plans, while ensuring that we remain in compliance with mandated standards," Mr. Thompson said.

Although the city pays the bills for its workers' pensions, all increases in public employees' pensions must be enacted by the State Legislature and approved by Governor [George E. Pataki](#). And the reports by New York City that it has sound pension plans have been cited again and again in Albany in the last few years, as lawmakers have granted billions of dollars worth of new benefits, often over the city's objections.

These new benefits were doled out on the understanding that the nation's seventh-largest pension system, counting both public and private plans, posed no threat to future generations of New Yorkers who must foot the bill.

Stuck With the Bill

On their face, New York City's pensions do not look particularly extravagant. As an example, a teacher retiring at age 55, after 30 years of service, could expect to receive a pension of about \$51,000 a year today. The New York City police, who are compensated extra for the risks they face on the job, can retire after 20 years, at any age, with pensions of about \$53,000 a year.

But compared with that of other workers — particularly in the private sector, where large companies have been freezing their pension plans and offering workers leaner benefits — the pensions are already

relatively generous and becoming more so.

In recent years, for example, city retirees were given annual cost-of-living increases in their pensions, a benefit virtually unheard of in the private sector. And the pension fund contributions that many workers had been required to make in the past were eliminated.

The state also added more jobs — most recently auto mechanics — to its list of “physically taxing” positions that entitle employees to retirement at age 50, or after they have served 25 years on the job, with full benefits.

In addition to the pensions, New York City has promised to pay for its retirees’ health care. The total cost of those obligations has not been tallied or reported yet, but Mayor [Michael R. Bloomberg](#) has estimated it at about \$50 billion in today’s dollars. (New York and other cities are adding up such obligations in response to a new accounting requirement.)

So, with the health care and the potential pension shortfall, New York City could have as much as \$100 billion in long-term obligations that it has never formally reported.

Mr. Bloomberg did not comment for this article, but in the past he has repeatedly expressed concern about Albany’s habit of unilaterally enacting new benefits that the city must pay for. “The question is, can the city residents pay for it?” he asked last week after the state promised more benefits to city employees, including some workers suffering health problems from 9/11.

While the city would like to do more for its workers, Mr. Bloomberg said, “if we pay for this, that will be some library that won’t be able to stay open an extra day. It’ll be some firehouse that we won’t be able to keep open. It’ll be some other project that everybody in this city wants. It’ll be the level of taxation, which is going to have to go up. Somebody’s got to pay for all of these things.”

New York City is not the only place where pension obligations may be far larger than reported. But comparisons are difficult. State and local government pension plans do not have to report their numbers according to any single actuarial methodology, as company plans do.

Government pension plans also have much greater latitude to fiddle with such critical assumptions as how long they expect their workers to live after retirement. And because they are not monitored by a federal guarantor or outside investors, they have not received the kind of scrutiny corporations have.

The magnitude of the potential discrepancy in New York City alone, which has often been held out as an exemplar in funding its pensions, suggests how poorly understood the looming public pension debt may be nationwide. New York State’s pension fund uses another reporting method, but it also tends to make the plan look fully funded at all times.

Uncertainty about the city’s pension numbers has attracted the New York State Insurance Department’s

attention, which has regulatory authority over public pension plans. The department has been auditing the city's pension plans and asking pointed questions about their financial health.

City officials who have been interviewed by the state regulators said they seemed interested in Mr. North's alternative method and asked whether the other public plans in New York State should be using it as well. A spokesman for the insurance department declined to discuss the audits.

Mr. North said New York City took on its unusual calculation for the purpose of determining the city's annual pension contribution, not as a financial status report.

But it does not show the volatility of the city's pension fund investments or the long-term soundness of the plans. Some of the other six approved models do, to some degree.

Other actuaries confirmed that the method was sound when used to speed up the financing of pensions. But they agreed with Mr. North that it gives a misleading picture of whether a plan is healthy or not.

Lost in the Fine Print

In 2003, when the pension funds were under severe financial strain — and their annual reports were still showing perfect health — Mr. North decided to start providing his alternative numbers.

He said he had wanted to publish them prominently, in the front of the plans' annual reports, but the city's outside auditors stopped him, because the accounting board had not approved the method he wanted to use. So the numbers ended up in the fine print, where few have noticed them.

Instead of basing his calculations on the investment returns the pension fund might earn in the future, Mr. North used very conservative investment returns — the type of returns now being paid by risk-free investments, such as Treasury bonds. He said he thought this was appropriate because the benefits are themselves risk-free, being guaranteed by the state constitution.

More analysts are beginning to question the rule that allows governments to base their pension values on anticipated investment returns. Doing so risks seriously understating the pensions' costs, they say.

“This is a really, really serious problem,” said Andrew L. Turner, a former managing director at the Frank Russell Company, a pension consulting concern in Tacoma, Wash. “The taxpayers think they're paying a lot less than what they're ultimately going to pay.”

But other specialists say Mr. North's risk-free method is inappropriate for governments. Ms. Stark, the city's finance commissioner, said it resembled the way corporations measure their pension plans in special circumstances, like a bankruptcy or during a merger. She said there was no reason to measure the city's pensions that way, because it was not going to go bankrupt.

The debate may sound arcane, but officials bring great passion to it because the amounts of money at stake are vast, and no one wants to make a mistake. Mr. Turner resigned from Frank Russell last year because of his growing conviction that the industry was habitually understating pension costs. He is now dean of the business school at Pacific Lutheran University.

“We’re doing this as a public trust,” he said, “and yet the weird way we’re doing it is, we’re going to end up breaching everybody’s trust.”

The new benefits New York City has added since 1999 have been politically popular. But they have also been very expensive. Even though they look modest on an individual basis, their cost adds up quickly because they have to be paid to many people who will be retired for many years.

The cost-of-living adjustment increased individual pensions by no more than \$540 in the first year, for example. But it increased the city’s total pension obligations by an estimated \$8.4 billion.

Even though the city’s contributions have risen greatly, New York has not been putting in the full amount necessary to keep up with the cost of the new benefits.

In 2000, when the cost-of-living adjustment was enacted, the Giuliani administration successfully lobbied Albany for permission to phase in the cost over five years. Then, in 2002, when the city was reeling from the stock market decline and the Sept. 11 attack, the Bloomberg administration won permission to stretch out the payment schedule even more, to 10 years. That saved the city more than \$200 million at a time when it was raising taxes, closing firehouses, and laying off workers to balance its budget.

This year, with its finances improving, New York City has persuaded the State Legislature to pass a bill eliminating the 10-year phase-in. That means the city will once again be keeping up with the contribution schedule that Mr. North has devised. But New York will still have to pay extra to catch up for the contributions it delayed.

Meanwhile, in Albany, representatives of the city’s labor unions are acting as if nothing has happened — and on paper, nothing did. There, the pension funds still look fully funded. Just this year, the Legislature passed dozens of bills to sweeten pensions for subway cashiers, school lunch helpers, crossing guards, locksmiths and others.

Governor Pataki vetoed most of the bills. But last week he signed one into law, over the city’s objection, that the city claims will cost \$5 million to \$10 million a year.

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