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State and Local Government - California

CalPERS' Reduction in Assumed Investment Returns is Credit Positive for Governments

On December 20, 2016, the largest US public pension system, the California Public Employees' Retirement System (CalPERS, Aa2 stable), reduced its assumed rate of investment return to 7.0% from 7.5%. The move is credit positive for the State of California (Aa3 stable) and many of its local governments, because it forces improved funding discipline of long-term liabilities, bringing reported costs and liabilities closer to their values under current market interest rates. Unlike the private sector or the liability adjustments we perform in our credit analysis, US governmental pension funding and accounting generally sets liability discount rates equal to the assumed rate of return on plan assets.

CalPERS' move heightens the importance of revenue growth to government credit profiles. Pension contribution requirements were already slated to rise materially under the 7.5% discount rate, and the lower reported discount rate will exacerbate this expenditure pressure. However, the alternative of an assumed rate of return above a level supported by market conditions would delay, but likely not prevent, the coming budgetary reckoning.

The lower discount rate assumption will force government contributions toward long-term liabilities to increase, but will lessen the risk of unanticipated contribution hikes in the future from adverse investment performance. Investment risk-taking needed to justify a discount rate above declining return expectations would translate to a heightened chance of investment losses, which could ultimately produce even higher contribution requirements.

Normal costs, which are the present value of current year benefit accruals, will increase by 1% to 5% of payroll for most plans administered under CalPERS due to the discount rate decline. Employees hired after California's Public Employees' Pension Reform Act (PEPRA) took effect in January 2013 will split the normal cost increase with employers, but participating governments must fund the entire normal cost increase for all other employees. In addition to normal cost increases, many participating governments will experience 30% to 40% increases in amortization payment requirements (in dollars) as a result of the change.

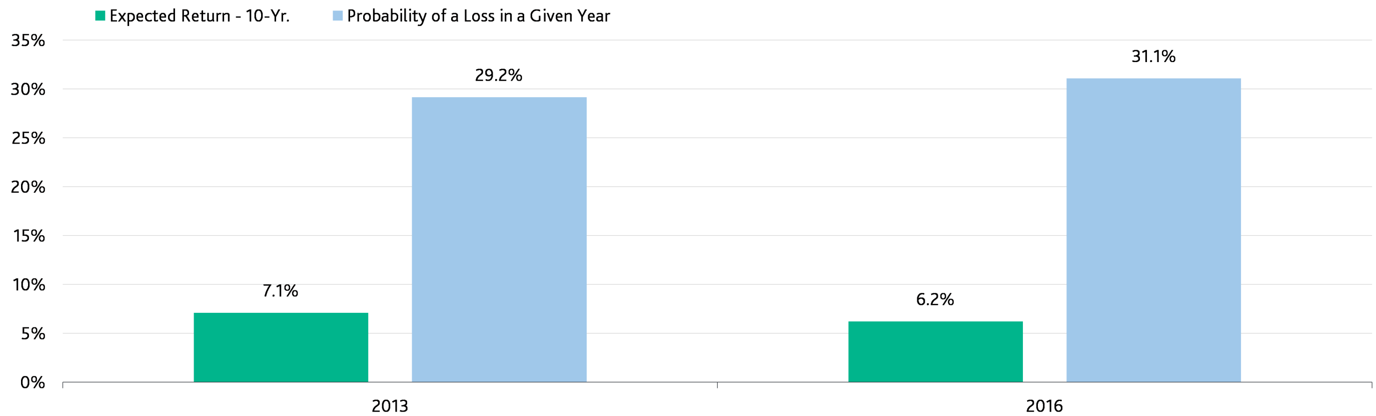
CalPERS will phase-in its discount rate change to soften the immediate budgetary impact. The state's contribution requirements for the fiscal years ending June 2018, 2019 and 2020 will be based on discount rates of 7.375%, 7.25% and 7.0%, respectively. The impact on contribution requirements for participating local governments, such as cities and school districts, will lag the state by one year.

CalPERS' decision to lower its discount rate is more aggressive than its risk mitigation plan adopted in 2015 to gradually lower its discount rate, reflecting the system's revised and less optimistic investment expectations. Compared to its 2013 study of investment conditions, CalPERS now expects lower returns in the next 10 years and greater risk (see Exhibit 1).

Exhibit 1

Greater Risk, Less Reward: CalPERS' Investment Return Expectations Exhibit Increasing Pessimism

CalPERS' updated 10-year return and risk expectations based on its asset allocation



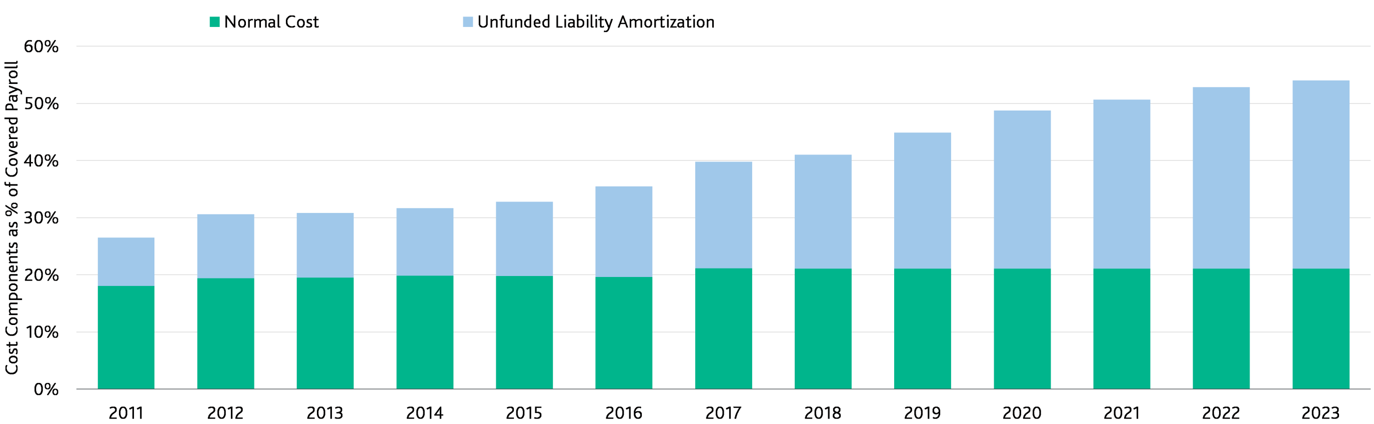
Moody's calculation of the probability of a loss in a given year assumes a normal distribution, and is based on return and standard deviation expectations presented at CalPERS' November 15, 2016 Finance & Administration Committee meeting.
Source: CalPERS, Wilshire Associates, Moody's Investors Service

The impact of the discount rate decline on contribution requirements will vary by plan and by government, but pensions clearly represent a significant expenditure driver for California governments, given the magnitude of cost increases that are expected by CalPERS. For example, even before accounting for the discount rate drop, government contributions for a representative public safety plan of a large city were projected to exceed 50% of payroll by fiscal 2023, compared to 27% in 2011. The increases are primarily driven by rising costs to amortize unfunded liabilities (see Exhibit 2).

Exhibit 2

Government Pension Contributions to CalPERS Were Already Projected to Increase Before the Recent Discount Rate Decline

Normal cost and amortization requirements for a sample large city's public safety plan as a % of payroll, before lowering of discount rate



Projections of future contribution requirements incorporate June 30, 2016 investment performance but do not reflect the discount rate decline just enacted. The discount rate decline will increase contribution requirements above the levels reflected above beginning in fiscal 2019 for local governments. Projected amortization costs as a % of payroll reflect CalPERS' 3% payroll growth assumption.
Source: CalPERS actuarial valuation for a large city's police plan as of June 30, 2015

Given mounting pension expenditure pressure, strong revenue growth is an increasingly important credit consideration for California and its local governments. For example, the revenue boost to the state from a recently approved income tax extension takes on even more budgetary significance in light of CalPERS' move. Most local governments in California, but not all, provide employees pension benefits that are administered under CalPERS. CalPERS' discount rate decision does not apply to the local plans it does not administer, primarily belonging to large cities and counties in the state.

The expected budgetary impacts from just a 50 basis point CalPERS discount rate decline, and the perceived need to spread its impact over multiple years, help demonstrate the increasing pension funding challenges facing California governments. At the same time, even the new 7.0% discount rate remains well above current market interest rates for fixed income payments of similar risk, timing and amount to promised pension benefits. For example, the Citigroup Pension Liability Index, which we rely on to value government pension liabilities as of their measurement date, was 4.14% as of December 31, 2016.

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