Leveraging public assets for pension solvency

MAY 2, 2019

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Contributing Editor at The Bond Buyer

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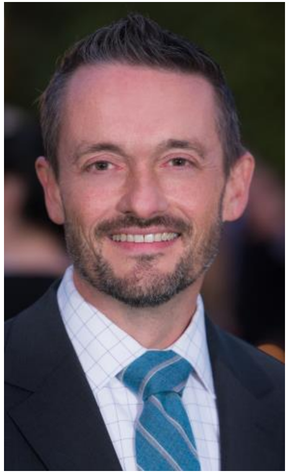

Leonard Gilroy

Sr. Managing Director, Pension Integrity Project at Reason Foundation

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Keith Brainard

Research Director, National Association of State Retirement Administrators

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LEVERAGING PUBLIC ASSETS FOR PENSION SOLVENCY

Leonard Gilroy
Vice President & Senior Managing Director, Pension Integrity Project

May 2, 2019

reason FOUNDATION

Webinar Overview

State and local policymakers facing pension solvency challenges are increasingly exploring the transfer/lease/sale of public assets to shore up underfunded public pension systems

Webinar will explore:

- Opportunities, challenges, and early lessons learned
- Case study demonstrating how one municipal government—Pittsburgh, PA—evaluated its options and decided which course to take
- The perspective of pension fund administrators

Context

- U.S. state and local public pension funds currently face over $1 trillion in unfunded liabilities
  - Drives interest in new solvency solutions
- In addition to structural reforms and increased pension contributions, some are seeking to leverage assets as part of solution set
  - Sales, leases, asset transfers (both physical assets and/or revenue streams)
- Not a new concept:
  - Proposed 2008 Chicago Midway Airport lease would have split 90% of net proceeds between pensions and infrastructure—deal scuttled amid Great Recession
  - Water & wastewater facility leases in Allentown, PA (2013) & Middletown, PA (2014)
  - Proposed 2013 sale of Philadelphia Gas Works—rejected by Council over labor provisions
  - 2017 NJ legislation transferring NJ Lottery proceeds to pensions
- Major reviews underway in New Jersey, Connecticut and Illinois now

Potential Opportunities

- Significant compatibilities between assets and pensions
  - Temporal nexus—long-term investors, long-lived assets
  - Some asset classes (e.g., toll roads, water) have long, attractive track record of returns and performance

- New infusions of the proceeds from asset sales/leases, transferred revenue streams, and/or transferred assets can potentially:
  - Improve pension solvency
  - Avoid interest paid over time on pension debt
  - Accelerate amortization of pension debt
  - Avoid budget crowd-out, future service cuts, tax increases
  - Improve the efficiency of asset management & shed non-core assets
  - Improve credit outlook
  - Facilitate new opportunities to improve service and modernize infrastructure

Risks with Asset Transfers

- Governments generally struggle with valuing public assets & tend to overvalue relative to the market
- Liquidity concerns—how difficult to sell the asset?
- Danger of booking future revenues before they materialize
    - Like pensions, real outcomes highly dependent on assumptions about revenue growth, etc.
    - Example: what if New Jersey residents stop playing Powerball, or dedicated pension tax revenues fall short?
- S&P Global (Feb 2019): *Are Asset Transfers A Gimmick Or A Sound Fiscal Strategy?*
    - "To the degree that they are based on unsubstantiated valuations, create liquidity concerns, or otherwise undermine long-term funding progress, S&P Global Ratings would view them as negative credit factors."

Risks with Asset Transfers (continued)

- Pension funds will take on operating responsibilities and risks of any transferred assets. Some examples:
  - *Revenue risk*—like pension returns, revenues are projected over decades, subject to assumptions and potentially volatile, like lotteries
  - *CapEx risk*—assets degrade and need to be rebuilt
  - *Regulatory risk*—changes in federal/state law and regulation
  - *Operating risk*—many risks inherent in some asset operations (see recent Cali fire and PG&E bankruptcy example)
  - *Social risk*—local community resistance can delay or even cancel infrastructure proposals; rates are a major driver
  - *Environmental risk*—risks of more stringent environmental regulations requiring infra upgrades (e.g., water plant filtration systems, etc.)

- Risk that policymakers will substitute for—not augment—traditional ER/EE pension contributions via asset transfer

- Leveraging assets without making needed reforms to address the underlying risks that led to underfunding in the first place

Policy Considerations

- Can you find a viable commercial framework where value can be captured?
- How do you ensure that the asset will improve alongside the pension system?
- If infrastructure investment is the goal, what are the relative merits of direct investment in projects versus pooled infra investment funds?
- How do you navigate political pressures that could dampen the commercial aspects of the transfer? (e.g., user fee rate setting, escalation, etc.)
- How do you avoid political decisionmaking seeking to drive local pension investment?
- A transfer is a transformation moment if properly done, to enhance value for both pensioners and asset users
- Infrastructure public-private partnership lessons:
  - Asset valuations are difficult—market discovery still most effective process
  - Despite differences in cost of capital, PPP can often drive equal or more value than alternative
  - Balancing act between commercial viability and public interest considerations

Questions?

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BIPARTISAN POLICY CENTER

Case Study: Pittsburgh's 2010 Evaluation of Options to Shore Up Its Pension Funds

May 2019

The Problem and Key Drivers

- Severely Underfunded Pension Reserves
- At Risk of State Takeover
- Concern about increased (& incremental) annual contributions

Pittsburgh’s Approach to Addressing the Problem

- Mayor’s Proposal
- City Controller’s Proposal
- City Council’s Directive
  - Articulate a full slate of options
  - Commission independent evaluation of the options
  - Open debate to public comment

Slate of Options

- Transfer the parking assets to the Comprehensive Municipal Pension Trust Fund
- Sell the parking assets owned by the parking authority
- Increase revenue by outsourcing management of the parking garages and meter system
- Issue a bond backed by increased parking revenue
- Lease the parking assets to a private-sector operator
- Agree to a state take over of the pension plan

Pittsburgh’s Evaluation of Using Parking Assets to make an In-Kind Contribution to the Pension Fund

- Significant legal barriers to transferring assets to the pension fund

- Operational hurdles

- Defeasance requirements related to outstanding bonds

Pittsburgh's Decision

- Not to pursue the option of an in-kind contribution
- City Council offered an alternative plan: invest in City's parking assets, raise rates and dedicate a portion of the increased revenue to the pension fund
- In December 2010, the City of Pittsburgh dedicated a portion of its annual parking tax revenue to its pension plans through 2041

View from Today

- The City of Pittsburgh is in stable condition according to recent reports from Moody's and Standard & Poor's
- Pension funding level at 56% (versus 34% in 2010)
- Annual contribution covering payouts
- S&P raise the city's debt rating to AA-
- City preparing to borrow $60 million to fund infrastructure needs
- Lessons Learned

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Primary Considerations

- Fiduciary duties
- Asset allocation
- Staff resources
- Investment performance
- Liquidity

Fiduciary Duties

- Public pension fund assets are held in trust for the exclusive benefit of plan participants
- Public pension trustees operate as fiduciaries
- Main fiduciary responsibilities:
  - Sole and exclusive loyalty to plan participants
  - Act with care, skill and diligence of a prudent person or prudent investor
  - Diversify investments

Fiduciary Duties and Infrastructure

- Public pension fund trustees may not make investment decisions solely or primarily on the basis that they will enhance local or regional economies or provide needed investment or jobs
- Investments must comply with the fund's investment policy
- Public pension investment policies typically describe how factors such as *risk, expected return, costs, liquidity, asset allocation strategy*, etc. are to be considered in the investment process

Public Pension Fund Asset Allocation

- Asset allocation is the single-most important decision public pension fund trustees make with respect to managing the portfolio
- Any public pension fund infrastructure investment must fit within the fund's asset allocation strategy and target asset allocation

Other Considerations

- Infrastructure investments require pension fund staff resources and expertise
- Not every fund has the resources and expertise, or access to them, needed to invest in infrastructure
- Other vital considerations for public pension funds are investment performance, net of fees; and liquidity

Liquidity

- The purpose of public pension funds is to pay benefits
- Public pension benefits must be paid in cash
- Any public pension fund investment eventually must be either liquidated or able to generate income
- Funds must consider their projected liability stream: when must benefits be paid?

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